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TAX REFORM PROPOSALS—XXIV

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 3, 1985

(Our Nation's Regulated Industries as Well as U.S. Possessions and Territories)

Printed for the use of the Committee on Finance

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TAX REFORM PROPOSALS—XXIV

THURSDAY, OCTOBER 3, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Symms, Grassley, Long, Matsunaga, Bradley, and Mitchell.

[The press release announcing the hearing follows:]

[Press Release No. 85-068, Thursday, August 9, 1985]

TAX REFORM HEARINGS BEFORE THE FINANCE COMMITTEE TO CONTINUE IN SEPTEMBER AND OCTOBER

Further hearings before the Senate Committee on Finance on the President's tax reform proposal will continue in September and October, Chairman Bob Packwood (R-Oregon) announced today.

"The Committee made significant progress in its tax reform hearing schedule in June and July," Senator Packwood stated. "Although the Committee will focus much of its attention on deficit reduction in the month of September, tax reform hearings will continue and will take us further toward our goal of getting a tax reform bill to the President before the end of this session of Congress."

The hearings announced by Senator Packwood today include:

On Thursday, September 19, the Committee will receive testimony on alternative tax reform proposals from witnesses invited by the Committee.

On Tuesday, September 24, the Committee will hear from public witnesses on the impact of tax reform on tax-exempt bonds.

On Thursday, September 26, public witnesses will present their views on the impact of the President's tax reform proposal on financial institutions and on the mining industry.

On Tuesday, October 1, the Committee will receive testimony on the impact of the tax plan on the insurance industry.

On Wednesday, October 2, witnesses representing the public will present testimony on the projected effect that tax reform will have on American business generally and, in addition, its impact on the foreign tax provisions.

On Thursday, October 3, the Committee will consider the views of public witnesses on the impact of the President's tax reform proposal on our nation's regulated industries, as well as those provisions relating to the United States' possessions and its territories.

All of the hearings scheduled by the Committee will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The CHAIRMAN. The committee will come to order, please.

This is the 32nd or 33rd, or 300th or 400th—I can't remember—hearing on the President's tax reform bill, and we have only a few more to go.

Today we are hearing on the issues of both the possessions' tax and the taxation of utilities and similar industries. We have a very distinguished group of witnesses today, including a very, very distinguished first panel consisting of Hon. Ron de Lugo, the Delegate from the Virgin Islands; Hon. Fofo Sunia, the Delegate from American Samoa; Hon. Jaime Fuster, the Resident Commissioner for the Territory of Puerto Rico; and Hon. Ben Blaz, the Delegate from Guam.

Is Mr. de Lugo here? If you have no objections, why don't we go ahead and start. We will put him on when he gets here, but why don't we start with Hon. Fofo Sunia, and we will go right down the list in that order.

Gentlemen, all of your testimony will be in the record in full, and to the extent you can abbreviate it and orally hit the high points of it, we would appreciate it.

Go right ahead, sir.

STATEMENT OF HON. FOFO I. F. SUNIA, DELEGATE, TERRITORY OF AMERICAN SAMOA

Mr. SUNIA. Thank you very much, Mr. Chairman, and good morning. I would like to ask at this point that the submission of my governor and one of my two industries, which I have appended to my own presentation, be incorporated as part of the record.

The CHAIRMAN. Without objection.

Mr. SUNIA. Thank you very much.

I would also like to thank you for the opportunity to offer some views on this issue, which we consider to be of grave importance to the economic welfare of our territory. Mr. Chairman, I do not plan to go over the same submission; I do have a one-page summary, and I would like to do that now.

The proposed changes to the possession tax credit bode that, in my territory, our only industry will defer or cancel plans to expand. Our one industry, the tuna canning industry, fears that these changes will affect its competition with extremely low wages in foreign markets. We need section 936 for the continued growth of our existing industry, and we need 936 in our efforts to become economically self-reliant.

The key to the private sector economy in American Samoa is the canning of tuna. Our two canneries produce 185,000 gross tons per annum and employ 3,775 persons, over 50 percent of the private-sector work force in my territory. This industry, the only industry, generates 40 percent of American Samoa's income tax revenue. Other businesses depend on it.

Combined with our partial tax exemption, section 936 has efficiently and effectively increased private sector employment. Under section 936, our sole industry, whose welfare is synonymous with that of our territory, saves $1,300 in taxes per employee.

The rationale for the proposed change in section 936 does not apply to American Samoa. This change posits that the present possession tax credit has not fulfilled its objective of increasing employment in the possessions and that it has cost too much. This is not true in the case of American Samoa.

Our American companies have just two options if they want to stay alive in the market: section 936 in the United States possessions, or purchase from foreign suppliers. So far, our companies have chosen to stay fully American, to use Americans to produce

American products in an American territory for American consumers.

Within 2 or 3 years of the coming into force of the proposed changes to section 936, the tuna industry will definitely construct new facilities in cheaper foreign locations. Production will move from American Samoa. To keep the American tuna industry American, it is most important that we maintain section 936 as it is today.

Thank you very much.

The **Chairman**. Thank you very much.

Now if we might go to the Resident Commissioner of Puerto Rico, Mr. Fuster.

[Mr. Sunia's written testimony follows:]

THE HONORABLE FOFO I.F. SUNIA

MEMBER OF CONGRESS FROM AMERICAN SAMOA

before the

SENATE COMMITTEE ON FINANCE

THURSDAY, OCTOBER 3, 1985

MR. CHAIRMAN, AS THE MEMBER OF CONGRESS FROM AMERICAN SAMOA, I THANK YOU VERY MUCH FOR THIS OPPORTUNITY TO SPEAK ON AN ISSUE OF GRAVE IMPORTANCE, SECTION 936 OF THE INTERNAL REVENUE CODE (IRC), THE POSSESSION TAX CREDIT.

THE PROPOSED CHANGES TO THE POSSESSION TAX CREDIT BODE THAT, IN MY TERRITORY, OUR ONLY INDUSTRY WILL DEFER OR CANCEL ANY PLANS TO EXPAND. OUR ONE INDUSTRY FEARS THAT THESE CHANGES WILL AFFECT ITS COMPETITION WITH THE EXTREMELY LOW WAGES IN THE PHILIPPINES AND THAILAND, ITS PRINCIPAL RIVALS. OUR ONE INDUSTRY NEEDS SECTION 936 TO REMAIN STRONG WHILE OPERATING IN THE AMERICAN POSSESSIONS. FOR ITS OWN WELFARE, WHICH IS SYNONYMOUS WITH THAT OF AMERICAN SAMOA, OUR ONLY INDUSTRY MUST BE IN A GOOD, COMPETITIVE POSITION.

MAY I ASK THAT YOU INCORPORATE AT THIS POINT IN THE RECORD A STATEMENT FROM THE GOVERNOR OF AMERICAN SAMOA AND A PRESENTATION FROM ONE OF OUR TWO MAJOR COMPANIES? BOTH SUPPORT THE RETENTION OF THE PRESENT SECTION 936.

FOR AMERICAN SAMOA THE CURRENT EXEMPTION AGREEMENT UNDER SECTION 936 OF THE IRC IS SUBSTANTIALLY BETTER THAN THE PROPOSED WAGE CREDIT SYSTEM. OUR SOLE INDUSTRY, TUNA CANNING, DEFINITELY WANTS TO EXTEND THAT SYSTEM FOR THE MAXIMUM PERIOD OF

TIME. A CHANGE IN THIS LAW WILL JEOPARDIZE ANY FUTURE INVESTMENT IN AMERICAN SAMOA AND EVEN LONG-RANGE CONTINUATION OF ITS FACILITIES. I SPEAK ONLY OF THE APPLICABILITY OF SECTION 936 TO AMERICAN SAMOA. I REALIZE THAT OTHER POSSESSIONS HAVE USED IT DIFFERENTLY.

ALTHOUGH MUCH OF THE PRESIDENT'S TAX PROPOSAL IS REVENUE NEUTRAL, THIS PROVISION, IF CONGRESS ADOPTS IT, WOULD HURT SIGNIFICANTLY MANY AMERICAN BUSINESSES NOW LOCKED IN A BITTER FIGHT WITH FOREIGN FOE. CONGRESS ORIGINALLY ENACTED SECTION 936 TO STIMULATE AMERICAN BUSINESSES IN AMERICAN POSSESSIONS, WHICH HISTORICALLY HAVE EXPERIENCED EXTREMELY LOW PER CAPITA INCOME RATES AND CHRONICALLY HIGH UNEMPLOYMENT. DUE TO SECTION 936 LABOR-INTENSIVE INDUSTRIES THAT DID NOT REQUIRE SKILLED WORKERS, SUCH AS TUNA CANNING, SET UP OR EXPANDED OPERATIONS IN THE AMERICAN POSSESSIONS. IN FACT, THIS INDUSTRY REPRESENTS ALMOST THE ENTIRE NONGOVERNMENTAL WORK FORCE IN AMERICAN SAMOA.

ONE OF THE MAIN REASONS FOR THE COSTLY RELOCATION OF AMERICAN TUNA PROCESSING WAS THE NEED TO BECOME MORE COMPETITIVE WITH EVER INCREASING IMPORTS OF CHEAP FOREIGN-CANNED TUNA. WHILE IMPORTS CONTINUE TO SURGE AT A STAGGERING RATE, UP OVER EIGHTY PER CENT IN 1985 FROM 1984, AMERICAN PROCESSORS HAVE AT LEAST LESSENED THE COMPETITIVE ADVANTAGE OF FOREIGN IMPORTS BY MOVING LABOR-INTENSIVE PROCESSING OPERATIONS TO AREAS THAT BENEFIT FROM SECTION 936 OF THE IRC, E.G. AMERICAN SAMOA.

I NOTE THE IRONY OF THE ADVENT OF THE PHASING OUT OF SECTION 936 SHORTLY AFTER THE INTERNATIONAL TRADE COMMISSION (ITC) DENIED THE TUNA INDUSTRY'S PETITION FOR IMPORT RELIEF. NOT ONLY DID

THE ITC BELIEVE THAT IMPORTS WERE ABATING, WHICH IN TRUTH THEY WERE NOT, BUT IT ALSO FELT THAT THE INDUSTRY WOULD BE MORE COMPETITIVE ONCE COMPANIES TRANSFERRED THEIR MAJOR PROCESSING OPERATIONS AND FIRMLY ESTABLISHED THEMSELVES IN AMERICAN SAMOA AND OTHER UNITED STATES POSSESSION.

IN URGING THAT CONGRESS NOT REDUCE THE PRESENT EFFECTS OF SECTION 936, I UNDERSTAND THAT WE NEED TO ADDRESS THE CURRENT DEFICITS. HOWEVER, I SUBMIT THAT THE ELIMINATION OF SECTION 936 WILL NOT CREATE INCREASED REVENUES BUT WILL IN ALL LIKELIHOOD EXACERBATE THE BUDGET AND TRADE DEFICITS. THOSE COMPANIES OPERATING UNDER SECTION 936 IN AMERICAN SAMOA DO SO TO BE MORE COMPETITIVE IN INTERNATIONAL TRADE. ELIMINATION OF SECTION 936 WILL FORCE AFFECTED AMERICAN INDUSTRIES TO CLOSE DOWN OPERATIONS IN AMERICAN POSSESSION AND TO JOIN THE EXODUS TO FOREIGN PRODUCTION. IF THIS OCCURS, THE UNITED STATES TRADE IMBALANCE WILL WORSEN AND UNEMPLOYMENT IN THE UNITED STATES POSSESSIONS WILL INCREASE.

THE SOLE INDUSTRY IN AMERICAN SAMOA HAS MUCH AT STAKE OVER THIS ISSUE. WHICHEVER TAX EXEMPTION BENEFITS THAT WOULD ACCRUE THERE WOULD AMOUNT TO ONLY A FRACTION OF THE WAGES THAT INDUSTRY PAYS TO WORKERS IN MY TERRITORY. THE THREAT OF THE ELIMINATION OF SECTION 936 HAS ALREADY WROUGHT DISADVANTAGEOUS CONSEQUENCES IN MY DISTRICT. ONE OF OUR TWO MAJOR COMPANIES INTENDED TO INCREASE ITS ANNUAL PRODUCTION CAPACITY IN AMERICAN SAMOA BY TWENTY-FIVE THOUSAND TONS, WHICH WOULD HAVE REQUIRED A CAPITAL EXPENDITURE OF APPROXIMATELY TEN MILLION DOLLARS. BECAUSE OF THIS TAX PROPOSAL, THIS COMPANY, ONE OF OUR PRINCIPAL EMPLOYERS IN THE PRIVATE SECTOR, HAS REDUCED THAT FIGURE BY FOUR MILLION DOLLARS.

IF CONGRESS IMPLEMENTS A WAGE-CREDIT SYSTEM TO REPLACE THE PRESENT SECTION 936, AMERICAN SAMOA WILL BECOME A LESS ATTRACTIVE PLACE FOR LONG-TERM CAPITAL INVESTMENT. THIS HAS FORCED ONE OF OUR TWO MAJOR COMPANIES TO RE-EVALUATE AND REDUCE ITS CAPITAL INVESTMENT PLANS AND EXPANSION. IT DOUBTS WHETHER IT WILL CARRY THROUGH WITH PREVIOUS PLANS FOR FURTHER OPERATIONS THAT WOULD BE HIGH-CAPITAL BUT LOW-LABOR.

I WOULD BE REMISS IF I DID NOT COMMENT ON THE TOTALITY OF THE PRESIDENT'S TAX PROPOSAL. EXCEPT FOR ITS TREATMENT OF THE POSSESSION TAX CREDIT, IT IS QUITE ACCEPTABLE TO AMERICAN SAMOA. IT REPRESENTS A GENUINE EFFORT TO REDUCE MANY OF THE ECONOMIC DEVELOPMENT PROBLEMS IN OUR RELATIONSHIP TO THE FEDERAL TAX COLLECTION SYSTEM. HOWEVER, THE LOW-PRICED IMPORTS OF CANNED TUNA HAVE FORCED AMERICAN COMPANIES TO CLOSE THEIR CANNERIES IN THE MAINLAND UNITED STATES. TO MEET FUTURE NEEDS, AMERICAN TUNA CANNING COMPANIES NEED THE CAPACITY TO PROCESS ABOUT THIRTY THOUSAND TONS OF RAW FISH PER ANNUM. THESE AMERICAN COMPANIES HAVE JUST TWO OPTIONS IF THEY WANT TO STAY ALIVE IN THE MARKET: CONTINUE EXPANSION IN THE UNITED STATES POSSESSIONS OR PURCHASE FROM FOREIGN SUPPLIERS. SO FAR OUR COMPANIES HAVE CHOSEN TO STAY FULLY AMERICAN, TO USE AMERICANS TO PRODUCE AMERICAN PRODUCTS ON AMERICAN TERRITORY FOR AMERICAN CONSUMERS. IF THIS ASPECT OF THE NEW TAX PROPOSAL GOES THROUGH, THIS CHOICE WILL BE ECONOMICAL FOR OUR MAJOR INDUSTRY FOR ONLY THE FIVE YEARS IN WHICH IT CAN MAINTAIN THE PRESENT SECTION 936 EXEMPTIONS. IT HAS ALREADY BEGUN TO ELIMINATE PERMANENT

CONSTRUCTION; IT COULD NEVER RECOVER THESE COSTS. THIS DEVELOPMENT WAS NOT THE INTENTION OF OUR ONE INDUSTRY.

WITHIN TWO OR THREE YEARS OF THE COMING INTO FORCE OF THE PROPOSED CHANGES TO SECTION 936, THE TUNA INDUSTRY WILL DEFINITELY CONSTRUCT NEW FACILITIES IN FOREIGN LOCATIONS MORE ECONOMICALLY FEASIBLE. PRODUCTION WILL MOVE FROM AMERICAN SAMOA. TO KEEP THE AMERICAN TUNA INDUSTRY AMERICAN, IT IS MOST IMPORTANT TO MAINTAIN SECTION 936 AS IT IS.

THE HONORABLE A.P. LUTALI

GOVERNOR OF AMERICAN SAMOA

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

OCTOBER 3, 1985

To substitute the present provisions of Section 936 with the wage credit will create some concern as to whether that will still make American Samoa a relatively attractive site for the United States corporation especially for the Tuna Industries.

The key factors in American Samoa private sector economy are the two tuna canneries. They employed approximately 40% of the private sector or 25% of the total American Samoa employment. Based upon expanded capacity of fish tonnage projected by both canneries to be packed in 1986, the two canneries are expected to employ over 50% of the American Samoa private sector work force. It should also be pointed out that the canneries provide over 40% of American Samoa's tax revenues.

The present provisions of Section 936, when combined with American Samoa's partial tax exemption program, without any question has been an efficient and cost effective mechanism for increasing private sector employment in American Samoa.

To repeal the present system of possessions' taxation without the substitution of meaningful incentive for doing business in the possessions, poses a threat that the canneries will leave American Samoa.

There are a number of low or no tax jurisdictions to which the canneries could move to and to compete with these jurisdictions, American Samoa has to reduce its effective tax rate presently ranging from 17% - 23%, with resulting reduction of overall tax revenues.

The United States would be called upon to make up any revenue loss, resulting from departure of the canneries or a reduction in their effective tax rates, through increased annual appropriation. The American Samoa Government continues to favor the present system as also supported by both canneries.

A P Lutali
Governor of American Samoa

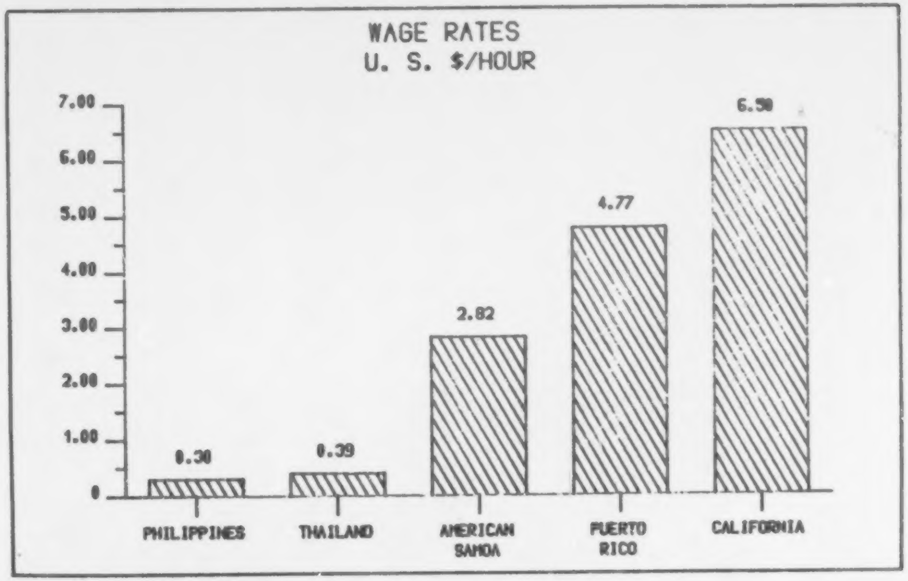
Star-Kist Foods, Inc.

A PRESENTATION
IN SUPPORT OF RETENTION OF
SECTION 936

11

1985

HISTORICALLY, THE CANNING OF TUNA WAS DOMINATED BY THE U.S. INDUSTRY WITH CANNERIES IN CALIFORNIA, HAWAII, PUERTO RICO AND AMERICAN SAMOA. WITHIN THE LAST SEVERAL YEARS FOREIGN PACKERS, PRINCIPALLY THE PHILIPPINES AND THAILAND, HAVE BECOME VERY AGGRESSIVE IN THE U.S. MARKETS, TAKING ADVANTAGE OF VARIOUS GOVERNMENT SUBSIDIES AND THE EXTREMELY LOW COST LABOR SUPPLY.



NOTE: 0.5-1.0 man-hours/case of 48-1/2# cans,
say $.10/can...Calif. vs. $.006/can...Thailand

IN THE LAST FEW YEARS, CANNED TUNA PRICES HAVE DROPPED DRAMATICALLY IN THE U.S., DUE TO AN "EXPLOSION" OF FOREIGN IMPORTS OF CANNED GOODS AT "CHEAP PRICES". AS A RESULT, STAR-KIST, VAN CAMP AND BUMBLE BEE WERE FORCED TO CLOSE THEIR HIGH COST (LABOR, ETC.) CALIFORNIA PLANTS AND RELY ON THEIR "OFFSHORE" FACILITIES IN PUERTO RICO AND SAMOA.

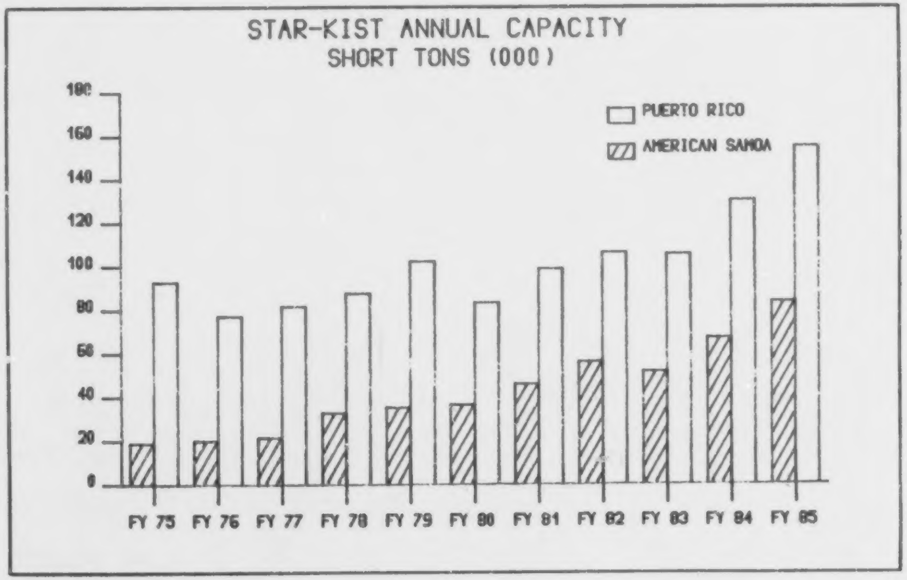
	1981	1982	1983	1984	Total Market
Imports of Canned Tuna (M Cases)	3,641	4,487	6,308	8,395	36,000
Canned Tuna Price Per Pound	$2.44	$2.52	$2.36	$2.17	xxxx

STAR-KIST "OFFSHORE" FACILITIES

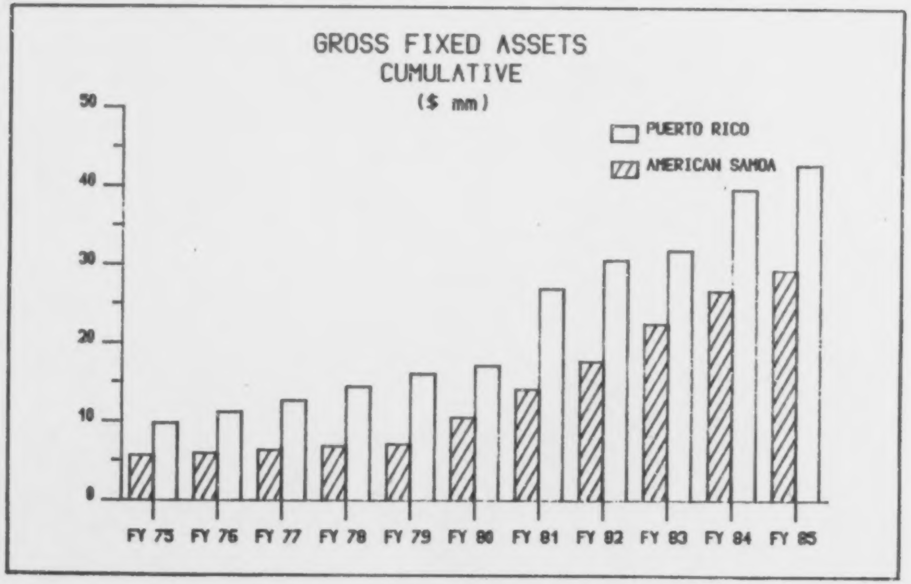
Star-Kist Caribe ... Mayaguez, Puerto Rico

Star-Kist Samoa ... Pago Pago, American Samoa

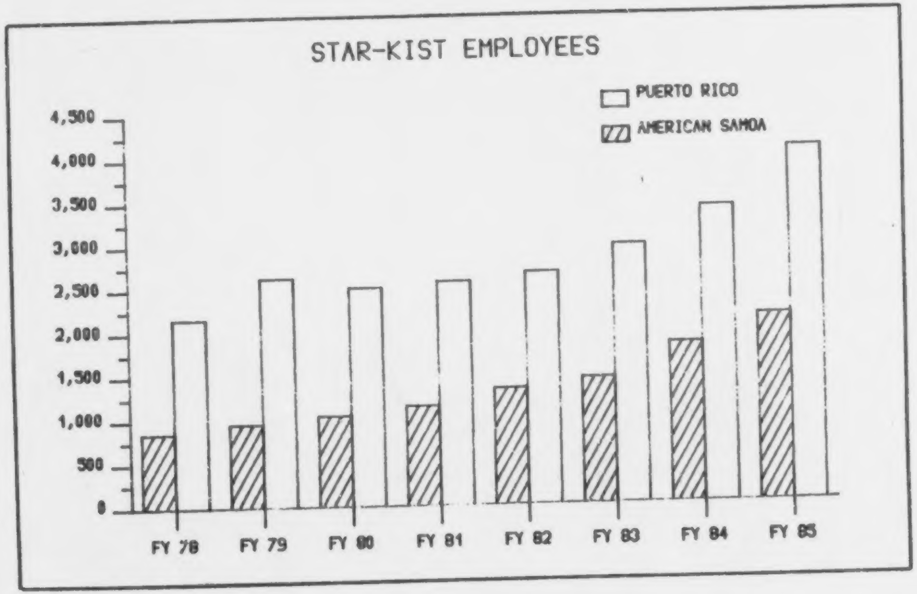
FORTUNATELY, OVER THE YEARS STAR-KIST HAS INCREASED ITS PRODUCTION CAPACITY AT PUERTO RICO AND AMERICAN SAMOA, SUCH THAT THESE PLANTS ARE NOW THE LARGEST AND SECOND LARGEST IN THE WORLD, RESPECTIVELY ...



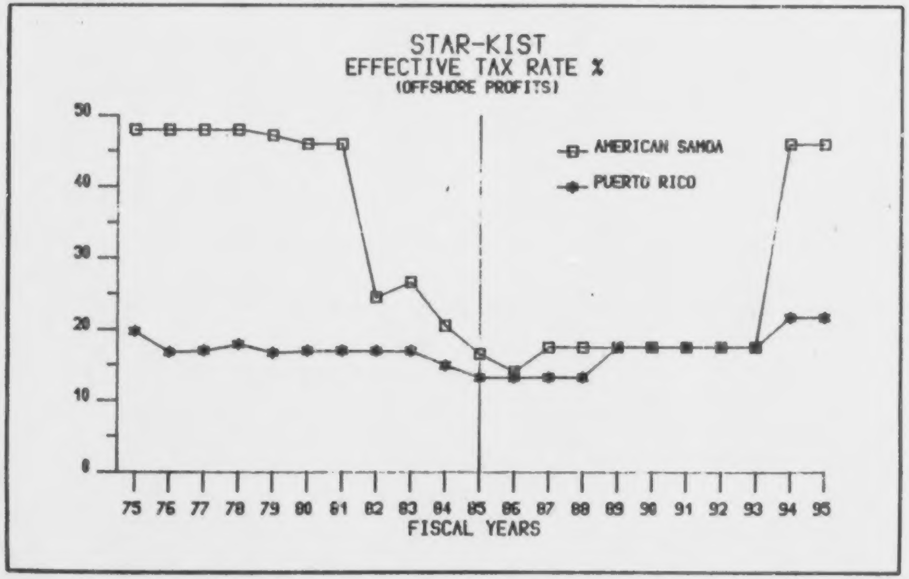
TO ACCOMPLISH THIS, STAR-KIST HAS INVESTED CONTINUOUSLY IN BOTH LOCATIONS ...



AND, CONCURRENTLY, HAS INCREASED EMPLOYMENT AT BOTH LOCATIONS .. LARGEST SINGLE EMPLOYER (AT ONE LOCATION) IN BOTH PUERTO RICO AND AMERICAN SAMOA.



WITH THIS INVESTMENT AND EMPLOYMENT COMMITMENT, AND THE PROVISIONS OF SECTION 936, STAR-KIST HAS TAX RATES AT BOTH LOCATIONS, WHICH HAVE PROVEN TO BE THE EQUALIZER, VERSUS THE LABOR COST ADVANTAGE ENJOYED BY THE "FOREIGNERS".



HOWEVER, EVEN WITH THE EXEMPTIONS, STAR-KIST PUTS MORE BACK INTO THE COMMUNITY THAN IT TAKES, JUST CONSIDERING THE LABOR COSTS, AND NOT COUNTING OTHER LOCAL EXPENDITURES, WHICH ARE SUBSTANTIAL.

IN SUMMARY, WE BELIEVE THAT ...

- STAR-KIST HAS COMPLIED WITH THE ORIGINAL SPIRIT AND INTENT OF THE AUTHORS OF SECTION 936 BY:

  ... INVESTING IN PUERTO RICO AND AMERICAN SAMOA,
  ... CREATING SIGNIFICANT EMPLOYMENT AND OTHER CONTRIBUTIONS TO THE LOCAL ECONOMIES,
  ... UTILIZING THE TAX INCENTIVES THAT WERE OFFERED IN RETURN.

- THESE INCENTIVES (EXEMPTIONS) WERE THE DRIVING FORCE BEHIND RECENT INVESTMENT DECISIONS, AND ARE NOW THE "EQUALIZER" THAT IS NECESSARY TO CONTINUE THE VIABILITY OF THE U.S. TUNA INDUSTRY.

- IT WOULD BE UNFAIR TO STAR-KIST, AND OTHER COMPANIES THAT HAVE MADE INVESTMENTS IN PUERTO RICO AND AMERICAN SAMOA BASED ON SECTION 936, TO CHANGE THE "GROUND-RULES" NOW.

- IN THE CASE OF STAR-KIST, AND THE TOTAL TUNA INDUSTRY OPERATING SIX FACTORIES IN PUERTO RICO AND AMERICAN SAMOA ... PHASEOUT OF SECTION 936 EXEMPTIONS WOULD ALMOST CERTAINLY RESULT IN PHASEOUT OF THE INDUSTRY ... TUNA IS A VERY IMPORTANT INDUSTRY TO PUERTO RICO (APPROXIMATELY 8,000 JOBS) AND VIRTUALLY THE ONLY INDUSTRY IN AMERICAN SAMOA (APPROXIMATELY 4,000 JOBS). RELOCATION TO FOREIGN COUNTRIES WOULD

STATEMENT OF HON. JAIME B. FUSTER, RESIDENT COMMISSIONER, COMMONWEALTH OF PUERTO RICO

Mr. FUSTER. Thank you, Mr. Chairman.

My name is Jaime B. Fuster. I am the elected Representative to the U.S. Congress for the 3.5 million American citizens of Puerto Rico, on whose behalf I come before you today. I am grateful for this opportunity to testify on a very vital issue. In fact, few matters are more important to my constituents than this one is, as any of you who might have seen any of our local newspapers lately would soon realize.

For 11 months now, our people have been hanging on every word, on every chance utterance, of almost anybody in Washington. While they wait to see what the Congress will do, our economy in Puerto Rico suffers because IRS section 936 is the cornerstone of hundreds of factories that are our economic lifeblood.

Many in Washington have been given the impression that section 936 is something that was dreamed up a little while back by a predecessor Congress to create jobs in Puerto Rico, which now must be changed or replaced because some companies have received substantial tax credits for the jobs they create or because Puerto Rico's unemployment rate is still unacceptably high. Such a narrow and constricted view of section 936 does great violence to the truth, which is apparent if one looks hard enough at the latest U.S. Treasury report on section 936, which recognizes that Puerto Rico's growth during the period from 1948 through 1973 has been an economic miracle.

The economic miracle referred to began in 1948 when Puerto Rico combined its own tax incentive program with the U.S. Possessions Corporation System of Taxation to produce a powerful incentive for U.S. businesses to establish themselves in the island. Before that, Puerto Rico, which already had experienced 50 years of U.S. control, remained mired in the depths of poverty and discontent while various Federal assistance programs were tried and found wanting. In the late forties, the combination of local and Federal tax incentives together with vigorous promotional efforts by the Government of Puerto Rico succeeded way beyond anyone's expectations in transforming the island into a free enterprise development showcase in the Caribbean.

The U.S. Treasury has complained that since 1974 Puerto Rico's economy has grown very little. Certainly, many things have happened during this period to cause an economic slowdown in the island. One factor that Treasury does not comment upon but which has been most salient is the uncertainty engendered by constant changes and the threat of change in the Federal tax law.

In 1973 and 1974 the Congress began a series of hearings on tax reform, including the Possessions Corporation System of Taxation. The Ways and Means Committee initially reached a decision to virtually eliminate the system but eventually was prevailed upon to make changes that we regard as improvements. The turnabout occurred because Congress finally realized, as it was concluded in a committee report on the Tax Reform Act of 1976, that the Federal tax incentive was needed as an offset to the competitive handicap imposed on investments in Puerto Rico by congressional requirements to pay Federal minimum wages and to use U.S. flagships in transporting goods to and from the mainland, a handicap which investments in neighboring countries did not suffer.

I am sure I do not need to remind you of what transpired in connection with the TEFRA in 1982, but you would have to have been in Puerto Rico to appreciate the convulsions generated by that scrape with disaster. In the intervening 6 years between the two bills, the investment climate was hardly peaceful. The IRS tried to do through regulation what the TEFRA in its Senate version would have done through law, and each year the Treasury produced a report emphasizing the negative. We still have not had enough time to find out whether or not Treasury's objections to 936 have been dealt with by TEFRA, but here we go again.

I have given you this brief history to remind you how much more is involved in this issue than Treasury's narrow and at times equivocal cost calculations. What is involved, to bring it down to its most basic terms, is a tax arrangement that serves the U.S. national interest very well.

To begin with, section 936 permits 250,000 American citizens in Puerto Rico to avoid Federal handouts or to avoid painful migration by allowing them to work to enjoy a respectable standard of living in their own home base and to purchase $5.5 billion worth of merchandise from the United States, creating roughly 150,000 jobs on the mainland.

Second, section 936 continues to serve the purpose it was created for—that is, to enhance the competitiveness of U.S. companies operating in U.S. insular jurisdictions. The high-technology electronics companies, in particular, should they lose their tax advantage in Puerto Rico, would either succumb to foreign competition or be forced to move offshore themselves, thus enlarging the ominous U.S. trade deficit.

Third, section 936 permits Puerto Rico's banking system and its government finances to remain in a healthy condition in these difficult times, helping the island to assure the service of its high $10 billion public debt which is owed mostly to U.S. institutions and individuals on the mainland.

Last, section 936 serves well the U.S. foreign policy interests, particularly in the Third World and the Caribbean Basin.

Section 936, in summary, is a successful program that works in ways big and small that do not begin to be captured by the static, arid, and unrealistic cost calculations which have been applied to it. It is a program which could come unraveled through excessive meddling and experimentation, as it is already beginning to do.

I trust, Mr. Chairman, that the Finance Committee will treat this issue with the seriousness it deserves and will recognize how unwise it would be to repeal or radically change section 936.

Thank you.

The CHAIRMAN. Thank you, sir.

Mr. Blaz.

[Mr. Fuster's written testimony follows:]

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NATIONAL PARKS AND RECREATION
MINING AND NATURAL RESOURCES

TESTIMONY OF THE HON. JAIME B. FUSTER
SENATE FINANCE COMMITTEE
October 3, 1985

Mr. Chairman members of the Committee:

My name is Jaime B. Fuster. I am the Resident Commissioner of Puerto Rico, the elected representative to the U.S. Congress of 3.5 million American citizens, on whose behalf I come before you today.

I am grateful for this brief opportunity to testify on an issue which so vitally affects the lives and the livelihoods of so many people that it deserves a great deal more attention than it can possibly get in one short hearing or in one provision of a massive, almost overwhelming tax bill. To most people concerned about fiscal reform, IRS Section 936 is only a minor part of the tax code. However, to my constituents, this appparently obscure provision could hardly be of greater importance, as any of you who might have seen any of our local newspapers lately would soon realize. For eleven months now our people have been hanging on every word, on every chance utterance of almost anybody in Washington, from the Chairman of the Finance Committee to the lowest level Treasury Department official. While they wait to see what the Congress will do, our economy in P.R. suffers because Section 936 is the cornerstone of hundreds of factories that are our economic life blood.

Many in Washington have been given the impression that Section 936 is something that was dreamed up a little while back by a predecessor Congress to create jobs in Puerto Rico, which now must be changed or replaced because some companies have received substantial tax credits for the jobs they create or because Puerto Rico's unemployment rate is still unacceptably high.

Such a narrow and constricted view of Section 936 does great violence to the truth, which is apparent if one looks hard enough at the U.S. Treasury's own Fifth Report on the Possessions Corporation System of Taxation which I quote:

> Puerto Rico's economic growth during the period from 1948 through 1973 has often been referred to as an "economic miracle"... Puerto Rican GNP... increased at an annual rate of 5.3 percent in the 1950s and 7.0 percent in the 1960s, compared to a U.S. average annual growth during the same period of 3.7 percent. Puerto Rico's remarkable growth was accompanied by the transformation of the agricultural economy of the 1940s to an economy based primarily on services and manufacturing."

The economic miracle referred to began in 1948 when Puerto Rico combined its own tax incentive program for manufacturing enterprises with the U.S. Possessions Corporation System of Taxation to produce a powerful incentive for U.S. businesses to establish themselves in the island. Before that, Puerto Rico, which already had experienced 50 years of U.S. control, remained mired in the depths of poverty and discontent while various federal assistance programs were tried and found wanting. In the late forties, the combination of local and federal tax incentives combined with vigorous promotional efforts by the Government of Puerto Rico succeeded, way beyond anyone's expectations, in transforming the island into a free enterprise development showcase in the Caribbean.

The U.S. Treasury has complained that since 1974 P.R.'s real GNP per capita has grown very little.

Certainly many things have happened during this period to cause an economic slowdown in the island. One of them has been the skyrocketing of the price of imported oil upon which Puerto Rico is completely dependent. Another one that the Treasury does not comment upon has been, perhaps, the most salient factor: I refer to the uncertainty engendered by constant changes and the threat of change in the federal tax law.

In 1973 and 1974 Congress began a series of hearings on tax reform. A main area which received attention was taxation on income earned outside the U.S., which included the possessions corporation system of taxation. The Ways and Means Committee initially reached a decision to virtually eliminate the system, but eventually was prevailed upon to make changes that we regard as improvements. The turnabout occurred because Congress finally realized, as it was concluded in a committee report on the Tax Reform Act of 1976, that the federal tax incentive was needed as an offset to the competitive handicap imposed on investments in Puerto Rico by Congressional requirements to pay federal minimum wages and to use U.S. flagships in transporting goods to and from the mainland, a handicap which investments in neighboring countries did not suffer.

I am sure I do not need to remind this Committee of what transpired in connection with the TEFRA in 1982, but you would have to have been in Puerto Rico to appreciate the convulsions generated by that scrape with disaster. In the intervening six years between the two bills the investment climate was hardly peaceful. The IRS tried to do through regulation what the TEFRA in its Senate version would have done through law, and each year the Treasury produced a report emphasizing the negative. We still have not had enough time to find out whether or not Treasury's objections to 936 have been dealt with by the TEFRA but here we go again.

I have given this brief history to remind you how much more is involved in this issue than Treasury's narrow and, at times, equivocal cost calculations. What is involved, to bring it down to its most basic terms, is a tax arrangement that serves the US national interest very well. To begin with, Section 936 permits 250,000 American citizens in P.R.-- one third of all of those employed in the island-- to avoid federal handouts or to avoid painful migration. It permits them to work to enjoy a respectable standard of living in their own home base, and to purchase $5.5 billion worth of merchandise from the United States, creating roughly 150,000 jobs on the mainland. Our combined prosperity is particularly important to the East Coast ports of the U.S. which ship a large percentage of those goods, as well as billions of dollars worth of products manufactured in Puerto Rico that are shipped out of the East Coast to foreign countries.

Secondly, Section 936 continues to serve a purpose it was created for, that is to enhance the competitiveness of U.S. companies operating in U.S. insular jurisdictions. The high-tech electronics companies, in particular, should they lose their tax advantage in Puerto Rico, would either succumb to foreign competition or be forced to move offshore themselves. In either case the ominous U.S. trade deficit would be enlarged. Thirdly, Section 936 permits Puerto Rico's banking system and its government finances to remain in a healthy condition in these difficult times, helping the island to assure the service of its high $10 billion public debt, which is mostly owed to institutions and individuals on the mainland. Lastly, Section 936 serves well the U.S. foreign policy interests, particularly in the Third World and the Caribbean Basin, demonstrating that it is possible for a heavily-populated tropical island with few natural resources to rise above the poverty level that so much of the world similarly situated, finds itself in today. And it permits Puerto Rico to assume the leadership role in the Caribbean that Governor Hernández Colón has mapped out with his plan for using 936 funds to promote manufacturing in neighboring islands and to invigorate the Caribbean Basin Initiative.

Section 936, in summary, is a successful program that works in ways big and small that do not begin to be captured by the static, arid, and unrealistic cost calculations which have been applied to it. It is a program which could come unraveled through excessive meddling and experimentation as it is already beginning to do. I trust that the Finance Committee will treat this issue with the seriousness it deserves and will recognize how unwise it would be to repeal or radically change Section 936.

STATEMENT OF HON. BEN BLAZ, DELEGATE, TERRITORY OF GUAM

Mr. BLAZ. Thank you, Mr. Chairman.

I also have a fairly lengthy statement, but I will just summarize it, in accordance with your wishes, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Mr. BLAZ. Mr. Chairman, I offer the following brief observations and comments in general support of President Reagan's tax reform proposal, in its treatment of the Territory of Guam under chapter 15.05. I have submitted a more detailed nine-page summary of my comments, which I respectfully request the Chair to enter for the hearing record.

The CHAIRMAN. Without objection.

Mr. BLAZ. In essence, Mr. Chairman, the President's proposal would permit Guam to continue administration and enforcement of the Federal Internal Revenue Code, as it has under the "mirror system" since 1950, until such time, after January 1, 1986, as the territory adopts its own tax code as would be permitted under such proposal.

The President correctly notes, in justifying granting such authority to the territory, that U.S. possessions generally derive a greater portion of their revenue from individuals in the lower income tax brackets and substantially less from corporations and higher income individuals.

As Mr. Dave Santos of Guam's Department of Revenue and Taxation, testifying later, will verify, 95 percent of Guam's taxpayers fall on or below the $40,000-per-annum income tax bracket. Our per-capita income is only $4,800 per year, $2,500 below the national average. Our median household income is $1,000 below the national average. Thirteen percent of our families live below the poverty level, 4 percent more than the average nationwide.

So, as you can see, and as the President's report recognizes, "Otherwise revenue neutral proposals that compensate for lowering tax rates by broadening the tax base may well not be, and are not, revenue neutral in a possession where very little tax is collected from corporations or higher income individuals."

Therefore, in order to promote fiscal autonomy and stability in possessions such as Guam, the President notes, and I quote, "It is important to permit each to develop a tax system that is suited to its own revenue needs and administrative resources."

Mr. Chairman, the Territory of Guam is ready, it is willing, and it is able to develop its own tax system compatible with those in effect at the time of its adoption in the 50 United States and the neighboring Commonwealth of the Northern Marianas and reflective of the highly competitive and attractive environment for investment offered by our neighbors in Japan, Hong Kong, Taiwan, and the Asian Continent.

Development of such a tax code will, however, take time. And until such code is enacted into law by the government of Guam, it is our desire, in assuming responsibility for administration of our own tax system next year, presuming congressional approval of this provision of the tax proposal, to continue application and enforcement of the IRC in Guam in its current form.

I stress retention of the current code because we estimate over $23 million, almost 15 percent of our entire local government revenue, would be lost were we to adopt the new tax rate structure as outlined elsewhere in the tax proposal. To adopt on January 1, 1986, or at some date thereafter, this new rate structure would be counterproductive to the tax proposal's stated objective of fiscal autonomy for the territory and similarly situated possessions. Both the President and the Ways and Means Committee have already embraced this proposal within their respective tax reform proposals.

Unanimous support for Guam's delinkage from the mirror tax system was offered recently by the Governor of Guam, the Guam Chamber of Commerce, three Guam legislators, and the U.S. Treasury Department before a September 10, 1985, hearing of the Joint Economic Committee's Subcommittee on Monetary and Fiscal Policy, which was chaired by Senator Steve Symms.

Mr. Chairman, Guam is a special place, and in our judgment it deserves special attention. In the 9 months that I have been seated as a Member of this Congress, I have been impressed, quite frankly, with the respect and courtesies extended to me. I do not believe Congress is inately sensitive to or benignly ignorant of Guam's needs, as some would allege. I do sense, however, a substantial lack of appreciation for what Guam can contribute to this country, not just strategically but economically. This is not altogether surprising. A February 7, 1985, General Accaunting Office report on issues affecting U.S. territorial and insular policy concluded, after almost 2 years of study, that "The United States has no overall strategy for encouraging economic development or promoting in a comprehensive and consistent fashion the private sectors in most of its territories."

I respectfully submit that with some fine tuning of sections 881(b), 935, and 936, particularly with respect to its application to our Caribbean possessions, the details of which I suggest be the subject of further discussions between our respective staffs and officials from the Treasury Department, President Reagan's tax proposal for the territories should serve as an integral component of a new Pacific Basin economic strategy.

As Guam emerges from its archaic territorial status to that of a modern commonwealth, in the midst of the most active international trade arena in the world, the freedom to enact a fair and reasonable tax structure will be critical, not only to Guam's development but to the Nation's as well. There can be perhaps no more effective deterrent to Soviet and other Communist insurgence in the Western Pacific than a healthy, thriving American economy, and it is Guam, again, which stands on our front line.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, sir.

Mr. de Lugo.

[Mr. Blaz's written testimony follows:]

TESTIMONY
ON
PRESIDENT REAGAN'S
PROPOSAL FOR COMPREHENSIVE TAX REFORM

BEFORE THE
SENATE FINANCE COMMITTEE

CONGRESSMAN BEN BLAZ
TERRITORY OF GUAM

October 3, 1985

MR. CHAIRMAN, I OFFER THE FOLLOWING OBSERVATIONS AND COMMENTS IN GENERAL SUPPORT OF PRESIDENT REAGAN'S TAX REFORM PROPOSAL IN ITS TREATMENT OF THE TERRITORY OF GUAM UNDER CHAPTER 15.05.

IN ESSENCE, THE PRESIDENT'S PROPOSAL WOULD PERMIT GUAM TO CONTINUE ADMINISTRATION AND ENFORCEMENT OF THE FEDERAL INTERNAL REVENUE CODE, AS IT HAS UNDER THE "MIRROR SYSTEM" SINCE 1950, UNTIL SUCH TIME, AFTER JANUARY 1, 1986, AS THE TERRITORY ADOPTS ITS OWN TAX CODE AS WOULD BE PERMITTED UNDER SUCH PROPOSAL.

THE PRESIDENT CORRECTLY NOTES, IN JUSTIFYING GRANTING SUCH AUTHORITY TO THE TERRITORY, THAT U.S. POSSESSIONS GENERALLY DERIVE A GREATER PORTION OF THEIR REVENUE FROM INDIVIDUALS IN THE LOWER TAX BRACKETS, AND SUBSTANTIALLY LESS FROM CORPORATIONS AND HIGHER INCOME INDIVIDUALS. IN FACT, 95% OF GUAM'S TAXPAYERS FALL ON OR BELOW THE $40,000 PER ANNUM INCOME TAX BRACKET. OUR PER CAPITA INCOME IS ONLY $4,800 PER YEAR, $2,500 BELOW THE NATIONAL AVERAGE. OUR MEDIAN HOUSEHOLD INCOME IS $1,000 BELOW THE NATIONAL AVERAGE. 13% OF OUR FAMILIES LIVE BELOW THE POVERTY LEVEL, 4% MORE THAN THE AVERAGE NATIONWIDE. SO, AS YOU CAN SEE, AND AS THE PRESIDENT'S REPORT RECOGNIZES, "OTHERWISE REVENUE NEUTRAL PROPOSALS THAT COMPENSATE FOR LOWERING TAX RATES BY BROADENING THE TAX BASE MAY WELL NOT BE (AND ARE NOT) REVENUE NEUTRAL IN A POSSESSION WHERE VERY LITTLE TAX IS COLLECTED FROM CORPORATIONS OR HIGHER INCOME INDIVIDUALS."

THEREFORE, IN ORDER TO PROMOTE FISCAL AUTONOMY AND STABILITY IN POSSESSIONS SUCH AS GUAM, THE PRESIDENT NOTES, "IT IS IMPORTANT TO PERMIT EACH TO DEVELOP A TAX SYSTEM THAT IS SUITED TO ITS OWN REVENUE NEEDS AND ADMINISTRATIVE RESOURCES." MR. CHAIRMAN, THE TERRITORY OF

GUAM IS READY, WILLING AND ABLE TO DEVELOP ITS OWN TAX SYSTEM COMPATIBLE WITH THOSE IN EFFECT, AT THE TIME OF ITS ADOPTION, IN THE 50 UNITED STATES AND THE NEIGHBORING COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS (CNMI) AND REFLECTIVE OF THE HIGHLY COMPETITIVE AND ATTRACTIVE ENVIRONMENT FOR INVESTMENT OFFERED BY OUR NEIGHBORS IN JAPAN, HONG KONG, TAIWAN AND THE ASIAN CONTINENT.

DEVELOPMENT OF SUCH A TAX CODE WILL, HOWEVER, TAKE TIME. AND UNTIL SUCH CODE IS ENACTED INTO LAW BY THE GOVERNMENT OF GUAM, IT IS OUR DESIRE, IN ASSUMING RESPONSIBILITY FOR ADMINISTRATION OF OUR OWN TAX SYSTEM NEXT YEAR, PRESUMING CONGRESSIONAL APPROVAL OF THIS PROVISION OF THE TAX PROPOSAL, TO CONTINUE APPLICATION AND ENFORCEMENT OF THE IRC IN GUAM IN ITS CURRENT FORM. I STRESS RETENTION OF THE CURRENT CODE BECAUSE WE ESTIMATE OVER $23 MILLION, ALMOST 15% OF OUR ENTIRE LOCAL GOVERNMENT REVENUE, WOULD BE LOST WERE WE TO ADOPT THE NEW RATE STRUCTURE AS OUTLINED ELSEWHERE IN THE TAX PROPOSAL. TO ADOPT ON JANUARY 1, 1986, OR AT SOME DATE THEREAFTER, THIS NEW RATE STRUCTURE WOULD BE COUNTER-PRODUCTIVE TO THE TAX PROPOSAL'S STATED OBJECTIVE OF FISCAL AUTONOMY FOR THE TERRITORY AND SIMILARLY SITUATED POSSESSIONS.

I SHOULD ALSO NOTE THAT THE PRESIDENT'S PROPOSED TREATMENT OF GUAM IN THIS TAX PROPOSAL IS ENTIRELY CONSISTENT WITH THE LANGUAGE CONTAINED IN GUAM'S DRAFT COMMONWEALTH ACT WHICH WILL LATER COME BEFORE THIS CONGRESS FOR REVIEW AND CONSIDERATION. ARTICLE 6 OF THIS DRAFT ACT, CURRENTLY UNDERGOING PUBLIC REVIEW IN GUAM, PROVIDES THAT "THE INCOME TAX LAWS ENFORCED IN THE UNITED STATES OF AMERICA AND THOSE WHICH MAY HEREAFTER BE ENACTED SHALL BE HELD TO BE LIKEWISE IN

FORCE IN GUAM." IN AFFECTING THIS PROPOSAL WITHIN THE LANGUAGE OF THE IRC, IT, IN EFFECT, BECOMES THE LAW OF GUAM UNDER THE COMMONWEALTH ACT, RETAINING THE AUTHORITY TO "DE-LINK" FROM THE FEDERAL IRC AND ADOPT A LOCAL TAX CODE.

THAT GUAM SHOULD BE VESTED WITH THE AUTHORITY TO "PICK AND CHOOSE" ITS OWN TAX CODE TO BE ADOPTED AT AN APPROPRIATE TIME, WHILE NOT A NEW CONCEPT, IS CERTAINLY A SOUND ONE. IN JANUARY OF 1983, THE DEPARTMENT OF THE INTERIOR POSED THE SAME OPTION TO THE GOVERNMENT OF GUAM THROUGH THE OFFICE OF TERRITORIAL AND INTERNATIONAL AFFAIRS. AT THAT TIME, THE GOVERNMENT OF GUAM'S RESPONSE WAS, AS IT WOULD BE NOW, TO SUPPORT THE GRANTING OF TAX AUTONOMY TO THE TERRITORY WITH THE RIGHT TO RETAIN ADMINISTRATION OF THE CURRENT IRC.

UNANIMOUS SUPPORT FOR GUAM'S DE-LINKAGE FROM THE MIRROR TAX SYSTEM WAS OFFERED RECENTLY BY THE GOVERNOR OF GUAM, THE GUAM CHAMBER OF COMMERCE, THREE GUAM LEGISLATORS, AND THE U.S. TREASURY DEPARTMENT BEFORE A SEPTEMBER 10, 1985 HEARING OF THE JOINT ECONOMIC COMMITTEE'S SUBCOMMITTEE ON MONETARY AND FISCAL POLICY. IN RESPONDING TO QUESTIONING FROM SUBCOMMITTEE CHAIRMAN, SENATOR STEVE SYMMS, AS TO THE BASIS FOR PROVIDING SUCH TAX AUTONOMY TO GUAM, MR. STEPHEN SHAY, DEPUTY INTERNATIONAL TAX COUNSEL FOR THE TREASURY DEPARTMENT, OFFERED THE FOLLOWING EXPLANATION WORTH RECOUNTING HERE FOR THE RECORD:

> THE INTERNAL REVENUE CODE IS A HIGHLY COMPLEX DOCUMENT AND IS DESIGNED FOR THE ECONOMY AS IT EXISTS IN THE MAINLAND UNITED STATES. GUAM'S ECONOMY HAS SOME CONSIDERABLY DIFFERENT FEATURES, AND, OF COURSE, GUAM HAS A SPECIAL RELATIONSHIP WITH THE UNITED STATES. IN COGNIZANCE OF THAT, WE FELT THAT IT WAS MORE REALISTIC ECONOMICALLY AND PROBABLY BETTER FOR THE MUTUAL INTEREST OF GUAM AND THE UNITED STATES TO ALLOW GUAM TO ATTEMPT TO FASHION ITS OWN INCOME TAX CODE WHICH WOULD BE SUITED TO ITS OWN NEEDS.

> WE HAVE SOME CAVEATS AND I THINK THEY'RE MUTUALLY AGREED UPON BY GUAM AND THE UNITED STATES. THE CAVEATS ARE SIMPLY THAT WE WILL BE BUILDING IN PROTECTIONS THAT WOULD PREVENT GUAM FROM BEING USED AS A TAX HAVEN, VIS-A-VIS, INVESTMENT IN THE UNITED STATES. UNDER OUR PROPOSAL, IF GUAM CHOOSES TO REDUCE REVENUES TO ATTRACT INVESTMENT IN GUAM, THAT WOULD BE PERFECTLY ACCEPTABLE AND OBVIOUSLY IS ONE OF THE CHOICES THAT'S AVAILABLE TO THEM. IT IS NOT INTENDED THAT THE PROPOSAL ALLOW NON-U.S. PERSONS TO OBTAIN BENEFITS FOR INVESTMENTS IN THE UNITED STATES WHICH WOULD NOT BE AVAILABLE TO OTHER U.S. TAXPAYERS.
>
> THE SECOND REASON FOR TAKING THIS APPROACH IS THAT WE HAVE HAD A HISTORY OF DIFFICULTY WHICH HAS BEEN, I THINK, REGRETTABLE ON BOTH SIDES THAT DERIVES FROM THE VERY COMPLEX INTERACTION OF APPLYING THE INTERNAL REVENUE CODE TO TRANSACTIONS THAT INVOLVE GUAM, AND I THINK THAT THIS PROPOSAL WOULD HELP SIMPLIFY THAT RELATIONSHIP AND AVOID UNINTENDED COMPLEX PROBLEMS THAT HAVE OCCURRED IN THE PAST.

AN APRIL 19, 1983 HERITAGE FOUNDATION REPORT ENTITLED "HOW GUAM CAN BECOME AMERICA'S HONG KONG" NOTED THAT, IN SEEKING PROSPECTIVE INVESTORS FROM HONG KONG, THE PHILIPPINES, SINGAPORE AND THAILAND, ALL PASSED MEASURES ATTRACTING SUCH INVESTORS TO THEIR RESPECTIVE JURISDICTIONS. THE REPORT HIGHLIGHTED GUAM'S LOCATION AS AN AMERICAN TERRITORY, LESS THAN 3 HOURS FLYING TIME FROM HONG KONG, TOKYO, SEOUL, MANILA AND TAIPEI. YET, THE REPORT NOTED, "GUAM LACKS THE SIMPLICITY AND CONSISTENCY IN ITS TAX CODE NEEDED TO ENCOURAGE SIGNIFICANT FOREIGN INVESTMENTS." IT NOTED FOR EXAMPLE, THAT THE APPEAL OF HONG KONG'S LOW, SIMPLE FLAT TAX OF 15% ON INDIVIDUALS AND 16.5% ON CORPORATIONS IN SPURRING ECONOMIC INVESTMENT AND GROWTH WAS SIMPLY NOT FULLY APPRECIATED BY THOSE OF US IN CONGRESS.

THIS IS OF PARTICULAR CONCERN TO US BECAUSE THE ASIA/PACIFIC FOREIGN INVESTOR WILL BE THE PRIMARY SOURCE OF THE PRIVATE CAPITAL NECESSARY TO FULLY DEVELOP OUR LOCAL ECONOMY. A FURTHER INEQUITY IN INTERNATIONAL TAX STATUTES PRESENTS A VERY REAL BARRIER TO THESE

FOREIGN INVESTORS.

AS YOU KNOW, THE TAX TREATMENT OF FOREIGN PERSONS DOING BUSINESS IN THE U.S. IS CONTROLLED BY TAX TREATIES. THESE TREATIES BETWEEN THE U.S. AND ALL MAJOR TRADING NATIONS IN THE WORLD (INCLUDING JAPAN) PROVIDE RELIEF FROM DOUBLE TAXATION AND WITHHOLDING TAXES DESIGNED TO PREVENT AVOIDANCE OF THE U.S. TAX SYSTEM. THESE TAX TREATIES, HOWEVER, DO NOT INCLUDE GUAM.

AS A RESULT, THE SAME ASIA/PACIFIC INVESTOR WILL PAY SIGNIFICANTLY HIGHER TAXES TO GUAM THAN WOULD BE NECESSARY IF HE OR SHE WERE DOING BUSINESS ANYWHERE ELSE IN THE U.S. ADMITTEDLY, THIS EXPENSE CAN BE REDUCED THROUGH ELABORATE FINANCIAL AND CORPORATE ARRANGEMENTS, BUT IT IS AN ARTIFICIAL AND COSTLY EXERCISE. WE WOULD BE BETTER SERVED TO HAVE THE SAME TAX TREATY PROVISIONS THAT APPLY TO THE U.S. AS A WHOLE APPLY TO GUAM. THIS WOULD PROVIDE AN ADDITIONAL INCENTIVE FOR FOREIGN INVESTORS TO ATTEMPT THE NECESSARY BUT POSSIBLY MORE MARGINAL VENTURES ON OUR ISLAND.

THE HERITAGE FOUNDATION REPORT FURTHER UNDERLINED CONGRESS' FAILURE TO FULLY APPRECIATE THE DIFFICULTIES INVESTORS IN GUAM FACE IN BEING SUBJECT TO EVERY CHANGE IN THE TAX LAW ENACTED BY CONGRESS AND EVERY TAX RULING ISSUED BY THE TREASURY DEPARTMENT - EVEN THOUGH NO GUAM REVENUES GO TO THE U.S. TREASURY. THE FOUNDATION CONCLUDED ACCURATELY THAT "FOREIGN INVESTORS, ENTERPRENEURAL LOCAL BUSINESSMEN AND MANY GUAMANIAN POLITICAL LEADERS RECOGNIZE THAT UNTIL THE STRAIGHT JACKET OF THE MIRROR TAX SYSTEM IS REMOVED, GUAM WILL NOT RIVAL OTHER BUSINESS CENTERS OF ASIA. ...IF THE FEDERAL GOVERNMENT WERE TO ACT QUICKLY TO REMOVE THE CURRENT OBSTACLES TO THE ISLAND'S DEVELOPMENT, IT COULD UNLOCK GUAM'S CONSIDERABLE POTENTIAL AND TRANSFORM THE TERRITORY INTO A NEW HUB OF TRADE AND A PLATFORM AND SHOWCASE FOR AMERICAN COMPANIES SEEKING TO DO BUSINESS IN THE ORIENT."

AND, MR. CHAIRMAN, WE HAVE MOVED QUICKLY IN ATTEMPTING TO REMOVE THOSE OBSTACLES TO OUR ISLAND'S DEVELOPMENT. I HAVE INTRODUCED H.R. 2225, AND REQUESTED AMENDMENTS TO H.R. 1562 AND S. 680, TO ENSURE THAT TEXTILE PRODUCTS MANUFACTURED IN GUAM RIGHTFULLY CONTINUE TO BE TREATED FOR TARIFF PURPOSES BY THE FEDERAL GOVERNMENT AS PRODUCTS OF AN INSULAR POSSESSION, NOT OF THE FOREIGN COUNTRY FROM WHICH CERTAIN RAW MATERIALS USED IN THEIR MANUFACTURE ORIGINATE. OUR LARGEST MANUFACTURING INDUSTRY, A TEXTILE OPERATION EMPLOYING 400 GUAM RESIDENTS, WILL BE CLOSED UNLESS THESE PROPOSALS RECEIVE YOUR FULL SUPPORT.

I HAVE INTRODUCED H.R. 2224 WHICH WILL PERMIT OTHER MICRONESIANS, CLASSIFIED UNDER OUR IMMIGRATION LAWS AS ALIENS, SERVING ON THE LARGE TUNA FISHING FLEET BASED IN GUAM TO DISEMBARK AT OUR COMMERCIAL PORT - A PRIVILEGE ALREADY ALLOWED CREWMEN ON BOARD FOREIGN FISHING VESSELS. WITHOUT YOUR SUPPORT OF THIS MEASURE, THE OVER $43 MILLION THIS INDUSTRY BRINGS INTO GUAM'S ECONOMY, INCLUDING OVER $4 MILLION IN TAX REVENUES, WILL LIKELY BE LOST.

WORKING WITH THE SUPPORT OF THE GENERAL SERVICES ADMINISTRATION, I HAVE INTRODUCED H.R. 2884, AND CALL YOUR ATTENTION TO ITS SIMILAR COMPANION, S. 1441, WHICH WILL ALLOW OVER 5,000 ACRES OF EXCESS FEDERAL LAND ON GUAM TO BE TRANSFERRED TO THE GOVERNMENT OF GUAM FOR USE IN DEVELOPING OUR AGRICULTURAL, RECREATIONAL, TOURISM, AND MANUFACTURING INDUSTRIES. VALUABLE PROPERTY ADJACENT TO OUR

COMMERCIAL PORT WILL BE FREED FROM PROVISIONS WHICH PROHIBIT REVENUES FROM LEASE OF SUCH PROPERTY FROM ACCRUING TO THE GOVERNMENT OF GUAM.

THESE ARE BUT A FEW EXAMPLES OF THE EFFORTS WE HAVE UNDERTAKEN ALREADY TO PROVIDE AN ENVIRONMENT CONDUCIVE TO GROWTH OF OUR PRIVATE SECTOR ON GUAM - BROADENING OUR TAX BASE AND ENSURING GREATER STABILITY IN AN ECONOMY TRADITIONALLY DEPENDENT PRIMARILY ON MILITARY-RELATED EXPENDITURES. WE RECOGNIZE THAT, THOUGH 9,000 MILES AWAY FROM THE NATION'S CAPITAL, WE IN GUAM SHOULD SHARE, ALONG WITH OUR MAINLAND COUNTERPARTS, IN BOTH THE BURDENS, AS WELL AS THE BENEFITS, OF PARTICIPATION IN THIS GREAT DEMOCRACY OF OURS.

WE HAVE SHOULDERED FAR TOO MANY OF THOSE BURDENS, FAR TOO LONG, HOWEVER. OUR ELDERLY, BLIND AND DISABLED ARE NOT ALLOWED PARTICIPATION IN THE SUPPLEMENTAL SECURITY INCOME (SSI) PROGRAM PROVIDED TO RESIDENTS OF ALL THE 50 STATES AND THE CNMI. THE LEVEL OF MEDICAID BENEFITS OUR RESIDENTS RECEIVE IS NOT CALCULATED IN ACCORDANCE WITH THE NORMAL FORMULAS APPLIED TO THE STATES, BUT LIMITED BY A CEILING IMPOSED BY FEDERAL LAW WHICH INCREASES SIGNIFICANTLY THE AMOUNT OUR LOCAL GOVERNMENT MUST CONTRIBUTE TO OUR RESIDENTS' HEALTH CARE.

FOREIGN-HULLED VESSELS MAY NOT SERVE GUAM FROM THE U.S. MAINLAND OR HAWAII AS THE JONES ACT RESTRICTS SERVICE TO GUAM TO U.S. VESSELS ONLY. HOWEVER, WE SIT EQUIDISTANT FROM THE BUSTLING SHIPPING PORTS OF TAIPEI, SEOUL, HONG KONG, MANILA AND JAPAN.

CURRENT CABOTAGE LAWS PROHIBIT THE MYRIAD OF INTERNATIONAL AIR CARRIERS TRAVERSING OUR SKIES FROM CARRYING PASSENGERS BETWEEN GUAM AND OTHER UNITED STATES DESTINATIONS. ONE OF ONLY THREE AIR CARRIERS

SERVING GUAM WAS FORCED TO CEASE OPERATIONS RECENTLY BY THE FAA BECAUSE OF VIOLATIONS OF NOISE REGULATIONS, REGULATIONS DESIGNED FOR METROPOLITAN AIRPORTS, NOT THOSE SUCH AS GUAM'S WHICH SERVE NAVY JET FIGHTERS AND B-52'S ON A REGULAR DAILY BASIS.

OUR ONCE LARGEST INDUSTRIAL OPERATION, THE GUAM OIL AND REFINING COMPANY, INC., WAS FORCED TO CLOSE BECAUSE, EVEN UNDER FEDERALLY-MANDATED SMALL BUSINESS SET-ASIDE PROGRAMS, IT COULD NOT COMPETE WITH MAINLAND SUPPLIERS - FOR SALE TO MILITARY INSTALLATIONS ON OUR OWN ISLAND. LOST WERE ONE-QUARTER OF A MILLION DOLLARS IN INCOME TAX REVENUES AND OVER A HALF MILLION DOLLARS IN BUSINESS PRIVILEGE TAXES.

IN 1983, EFFORTS BY THE GOVERNMENT OF GUAM TO LEGITIMATELY FLOAT SEVERAL HUNDRED MILLION DOLLARS IN ARBITRAGE BONDS IN AN ATTEMPT TO DECREASE RELIANCE ON FEDERAL HANDOUTS AND SUBSIDIES, WERE THWARTED IN MIDSTREAM BY AN EMERGENCY REGULATION OF THE U.S. TREASURY DEPARTMENT. $13 MILLION IN POTENTIAL TAX REVENUES WERE LOST. AFTER DRAFTING A COMPREHENSIVE DEFICIT ELIMINATION PLAN, AS MANDATED BY CONGRESS AS A PREREQUISITE TO, AND IN ANTICIPATION OF, RECEIPT OF $37.5 MILLION IN AUTHORIZATIONS, THE GOVERNMENT OF GUAM HAS NOT RECEIVED ONE PENNY FROM CONGRESS IN APPROPRIATIONS. SUCH AUTHORIZATION EXPIRED LAST YEAR. OVER $27 MILLION IN LOCAL TAX REVENUES HAVE BEEN LOST OVER THE LAST THREE YEARS SINCE IMPLEMENTATION OF THE TEFRA AND ERTA PROVISIONS ALONE.

MR. CHAIRMAN, I COULD GO ON WITH FURTHER EXAMPLES, BUT THE POINT I WISH TO MAKE SHOULD BE CLEAR. GUAM IS A SPECIAL PLACE; IT DESERVES SPECIAL ATTENTION. IN THE 9 MONTHS SINCE I WAS SEATED AS A MEMBER OF THIS CONGRESS, I HAVE BEEN IMPRESSED, QUITE FRANKLY, WITH THE RESPECT

AND COURTESIES EXTENDED ME AS A NON-VOTING DELEGATE. I DO NOT BELIEVE CONGRESS IS INATELY INSENSITIVE TO, OR BENIGNLY IGNORANT OF, GUAM'S NEEDS, AS SOME WOULD ALLEGE. I DO SENSE, HOWEVER, A SUBSTANTIAL LACK OF APPRECIATION FOR WHAT GUAM CAN CONTRIBUTE TO THIS COUNTRY, NOT JUST STRATEGICALLY, BUT ECONOMICALLY. THIS IS NOT ALTOGETHER SURPRISING. A FEBRUARY 7, 1985 GENERAL ACCOUNTING OFFICE (GAO) REPORT ON "ISSUES AFFECTING U.S. TERRITORIAL AND INSULAR POLICY" CONCLUDED, AFTER ALMOST 2 YEARS OF STUDY, THAT "THE UNITED STATES HAS NO OVERALL STRATEGY FOR ENCOURAGING ECONOMIC DEVELOPMENT OR PROMOTING IN A COMPREHENSIVE AND CONSISTENT FASHION THE PRIVATE SECTORS IN MOST OF ITS TERRITORIES."

I RESPECTFULLY SUBMIT THAT, WITH SOME FINE TUNING OF SECTIONS 881(B), 935 AND 936 (PARTICULARLY WITH RESPECT TO ITS APPLICATION TO OUR CARIBBEAN POSSESSIONS), THE DETAILS OF WHICH I SUGGEST BE THE SUBJECT OF FURTHER DISCUSSIONS BETWEEN OUR RESPECTIVE STAFFS AND OFFICIALS FROM THE TREASURY DEPARTMENT, PRESIDENT REAGAN'S TAX PROPOSAL FOR THE TERRITORIES SHOULD SERVE AS AN INTEGRAL COMPONENT OF A NEW PACIFIC BASIN ECONOMIC STRATEGY. AS GUAM EMERGES FROM ITS ARCHAIC TERRITORIAL STATUS TO THAT OF A MODERN COMMONWEALTH, IN THE MIDST OF THE MOST ACTIVE INTERNATIONAL TRADE ARENA IN THE WORLD, THE FREEDOM TO ENACT A FAIR AND REASONABLE TAX STRUCTURE WILL BE CRITICAL NOT ONLY TO GUAM'S DEVELOPMENT, BUT TO THE NATION'S AS WELL. THERE CAN BE PERHAPS NO MORE EFFECTIVE DETERRENT TO SOVIET AND OTHER COMMUNIST INSURGENCE IN THE WESTERN PACIFIC THAN A HEALTHY, THRIVING AMERICAN ECONOMY, AND IT IS GUAM, AGAIN, WHICH STANDS ON OUR FRONT LINE.

THANK YOU.

STATEMENT OF HON. RON de LUGO, DELEGATE, TERRITORY OF THE VIRGIN ISLANDS

Mr. DE LUGO. Thank you very much, Chairman Packwood.

Let me apologize to you and to Senator Long for my tardiness. There is a bit of traffic out there, and it took me longer to get over from the House side than I had anticipated.

Let me thank you for the courtesies of having us before your committee this morning on the tax reform proposal, and let me address myself very briefly just to one subject. I will be very brief. First of all, I would like to ask that my detailed formal statement be made a part of the record.

The CHAIRMAN. Without objection.

Mr. DE LUGO. Thank you very much, Mr. Chairman.

Very briefly, let me associate myself with the statements that were made by my colleague the Resident Commissioner of Puerto Rico, Jaime Fuster, and also Delegate Ben Blaz, regarding 936, which reflects itself in our area as 934. The retention of this is paramount, I believe, to our area. And that has really worked for the United States in the Caribbean area; but I am sure that the Governor of Puerto Rico will address himself to that.

I would like to address myself to just one subject, and it is something that may not even make itself all the way over here to the Senate; but it is of critical importance to the U.S. Virgin Islands. It is something that has just come up as a staff option before the Ways and Means Committee on the House side, and that is a proposal to eliminate the mirror system on taxation as applied to the U.S. Virgin Islands.

Now, the people of the U.S. Virgin Islands have always taken considerable pride in their status as part of this country. And whether it is essential to the relationship or not, the mirror of the Internal Revenue Code is perceived in our area as an important facet of this Union. To suggest such a radical change to the structure of the Territory's relationship with the Federal Government in the context of massive tax reform, I believe is inappropriate.

What is particularly disturbing about the proposed elimination of the mirror system of taxation is that it appears to be born of a lack of interest in sorting out the tax issues related to continuing the mirror, compounded by the lack of time given the pressure to resolve the national tax problems. In other words, it is just easier to not face up to the problem and just eliminate it that way.

I believe that a proposal to eliminate the mirror system for the Virgin Islands cannot be adequately analyzed in the context of tax reform legislation currently under consideration. Such an issue should be considered by both the committees with direct jurisdiction over the Territories, and the tax committees, and this can only be realistically done in the context of separate legislation.

Furthermore, the President has proposed no such change for the Virgin Islands under Treasury-II. Instead, the President's proposal suggests modifications of the mirror, roughly based on discussions that have been going on for a period of 2 years between the Government of the Virgin Islands and the Treasury Department here. So, I believe that actually this will be resolved and will not even get over here to the Senate; but it is of such importance to us that I just wanted you to be alerted to it.

I thank you for your courtesy.

[Mr. de Lugo's written testimony follows:]

STATEMENT BY RON DE LUGO, M.C.
BEFORE THE FINANCE COMMITTEE
ON
COMPREHENSIVE TAX REFORM
AS IT AFFECTS THE UNITED STATES VIRGIN ISLANDS

OCTOBER 3, 1985

Mr. Chairman and Distinguished Members of the Committee, I appreciate this opportunity to discuss with you the proposed tax reform as it would affect the United States Virgin Islands. Most significant from the Virgin Islands perspective is the proposal, currently before the Ways and Means Committee, to eliminate the mirror system of taxation as applied to the Virgin Islands. Any tax policy consideration which may have militated in favor of this solution pales in comparison to the territorial policy statement made.

The people of the Virgin Islands have always taken considerable pride in their status as part of this country. Whether essential to that relationship or not, the mirror of the Internal Revenue Code is perceived as an important facet of this union. To suggest such a radical change in the structure of the territory's relationship with the federal government in the context of massive tax reform is, I suggest, inappropriate.

What is particularly disturbing about the proposed elimination of the mirror system of taxation is that it appears to be born of a lack of interest in sorting out the tax issues related to continuing the mirror, compounded by the lack of time given the pressure to resolve the national tax problems. I submit, therefore, that a proposal to eliminate the mirror tax system cannot be adequately analyzed in the context of the tax reform legislation currently under consideration. Such an issue should be considered by both the committees with direct jurisdiction over the territories and the tax committees, and this can only realistically occur in separate legislation.

Furthermore, the President has proposed no such change for the Virgin Islands under Treasury II. Instead, the President's proposal suggests modifications of the mirror, roughly based on discussions, over a period of two years, with the government of the Virgin Islands.

I urge this Committee not to adopt any proposal that would eliminate the mirror system of taxation as it applies to the U.S. Virgin Islands. Such a proposal is alienating for the people of the Virgin Islands, and raises questions of territorial policy which I do not believe the federal government is prepared to answer.

This fundamental concern raised, I will go on to discuss matters relating to the continuation of the mirror, and ways in which the laws effecting the mirror may be amended in the spirit of fairness, simplicity and growth.

The Governor of the Virgin Islands has consulted on the impact of the President's proposal, which, I repeat, does not suggest a termination of the mirror, with a task force in the Virgin Islands composed of representatives from his staff and cabinet, from the business community and from my staff. The task force recommendations are reflected in the Governor's written statement. I fully endorse the recommendations made in that statement.

As the Governor will discuss in some detail, the reform of the mirror suggested in the Treasury II proposal for individual taxpayers in the Virgin Islands meets the Administration objectives of fairness and simplicity, without inhibiting the economic growth of the territory. This is not true with regard to the corporate tax provisions. Outright repeal of the "inhabitant rule", set out in section 28(a) of the Revised Organic Act, would (1) require U.S. corporations doing substantially all of their business in the Virgin Islands to pay U.S. tax on their V.I. source income for the first time, and (2) contrary to current law, require a V.I. or U.S. inhabitant corporation to pay tax on its U.S. source income to the U.S rather than to the Virgin Islands. In discussing modifications of the "inhabitant rule" over the past few years, the Virgin Islands government and the Treaury Department agreed, in principal, that this outcome was a reasonable solution, provided both the U.S. and Virgin Islands corporations operating in the Virgin Islands could benefit from the dividends received deduction currently enjoyed by the other insular areas, and assuming continued benefits under 936. No proposal to replace the 936 benefits with a wage credit was intimated.

The Treasury II proposal to replace the existing 936 benefits with a wage credit is designed to attract labor intensive as opposed to capital intensive industry to the U.S. insular areas. For the Virgin Islands, repeal of the "inhabitant rule" means that section 934(b) benefits as applied to U.S. corporations in the Virgin Islands would be replaced with the section 936 wage credit. The wage credit would cut off qualified U.S. investment in the U.S. insular areas on the premise that the investment does not yield sufficient jobs in relation to the revenues foregone by the United States. But the analysis provided is artificial. Treasury II does not take into account the employment generated by industries which support the existing 936 and 934(b) firms. The tax incentives provided to the U.S. insular areas exist because Congress has recognized that it is difficult for U.S. jurisdictions, especially those offshore, to compete for labor intensive investment. Labor intensive industry willing to consider an offshore location will generally look for areas which promise freedom from federal regulation and low wages, in addition to low levels of taxation. It is unlikely that the wage credit will be sufficient to offset the draw to foreign countries. Further, the proposed credit would not be applicable to the most obvious labor intensive industries in the insular areas, hotels or other tourist related industry.

The Ways and Means Committee is considering legislation that would retain the 936 tax credit, with modifications as applied to intangibles and passive income. This would be far more workable for the Virgin Islands, if 936 is to apply to U.S. corporations in the Virgin Islands. Nonetheless, without the concurrent ability to repatriate tax-free earnings to a U.S. shareholder or parent, modification of the "inhabitant rule" yields a disincentive to U.S. investment through local corporate entities.

This year the Administration plans to submit enterprise zone legislation to the Congress similar to that introduced last year. The enterprize zone legislation that we have seen consists of a series of tax incentives targeted at economically depressed mainland jurisdictions, and designed to provide the answer to their economic problems. The same principal obtains for the Virgin Islands and the other U.S. insular areas. Through section 28(a) of the Revised Organic Act and Code sections 934(b) and 936, Congress has put in place tax incentives which form the basis for industrial development in the insular areas. These incentives flow from the unique relationship each of these areas has developed within the United States, and respond, in part, to the problems this country's offshore jurisdictions face in attracting industry. The Administration's interest in enterprize zones demonstrates its confidence in the need for targeted incentives such as those I ask you to continue for the insular areas of the United States.

In the spirit of tax reform, the Virgin Islands proposes several positive steps that could be taken to enhance this territory's economy, without an impact on federal revenues. In addition to the corporate changes initially agreed upon, as discussed above, Treasury II suggests that the Virgin Islands should be encouraged to attract foreign investment. The proposal would permit the Virgin Islands to reduce the Virgin Islands tax liability of a non-U.S. controlled corporation on Virgin Islands and foreign source income without regard to the gross income tests under section 934(b) of the Code, and reduce the 30 percent withholding tax on certain investment income earned by non-U.S. controlled persons. This would enable the Virgin Islands to compete for capital intensive as well as labor intensive foreign investment. It is consistent with the situation in other U.S. insular areas which are not subject to the mirror. I do believe, however, that, in addition to encouraging foreign investment, it is important to keep the channels for U.S. investment in these U.S. areas open. The Virgin Islands clearly wants to maintain its American character. This concern has played its part in the territory's decision to hold on to the mirror, and should militate in favor of maintaining incentives for American investment.

I know that the Administration has created the momentum for tax reform through its Treasury proposals. I believe that as the Congress looks closely at Treasury II there will be items affecting individual and corporate taxes that do not stand up to the test of fairness, simplicity or the fostering of growth. I submit that the changes proposed for section 28(a) of the Revised Organic Act and section 936 are not beneficial under this test, nor do they achieve what may ultimately be the litmus test of tax reform in that they would net a revenue loss for the Treasury. The United States will, in one form or another, remain responsible for the welfare of its insular areas. We ask for the opportunity to achieve economic health by working for it. We also ask for the opportunity to develop our economies through a thoughtful exchange which encompasses this country's interest in the future of its insular areas as well as its desire for a pristine tax code.

The CHAIRMAN. Let me ask you a question about the mirror. Puerto Rico, of course, has its own tax system now; it doesn't use the mirror.

Mr. DE LUGO. Right.

The CHAIRMAN. The other three of you, at the moment, are using the mirror. Only the Virgin Islands, as I understand it, is opposed to the change but, correct me if I am wrong, all the change does is allow you to adopt your own tax system, doesn't it?

Mr. DE LUGO. Senator, Puerto Rico has never had the mirror.

The CHAIRMAN. Right.

Mr. SUNIA. American Samoa does not have the mirror.

Mr. DE LUGO. And the Territory of Guam, as was stated here today by their Delegate, their determination is that they would like to write their own tax system, their own tax plan. We in the Virgin Islands do not want to do this, for a number of reasons. We feel that the Federal tax plan is seen as a sign of stability; we feel that if we were to get into writing the tax plan and developing this complex plan at this time, that it would further slow down investment in the U.S. Virgin Islands.

The CHAIRMAN. Even if you did nothing but, on your initiative, say, "We adopt the U.S. Tax Code?" I mean, you would be at liberty to adopt, in essence, the mirror if you wanted, as I understand it.

Mr. DE LUGO. Yes, that is true, Mr. Chairman, we could do that, but we prefer to stay with the mirror.

The CHAIRMAN. Let me go down the line now and start with you, Mr. de Lugo, and ask: What is the unemployment in your respective areas?

Mr. DE LUGO. The unemployment in the Virgin Islands, I believe, is in the area of 8 percent at the present time.

Mr. SUNIA. We have a similar percentage.

The CHAIRMAN. About 8?

Mr. SUNIA. Yes, sir.

Mr. FUSTER. Close to 23 percent.

Mr. BLAZ. We are 9 to 12 percent, sir. It vacillates.

The CHAIRMAN. I am curious: Why the extraordinary difference in Puerto Rico? Can you tell us why?

Mr. FUSTER. Well, Mr. Chairman, to begin with, there are close to 3.5 million people in an island that is 100 miles long and 35 miles wide. You would have to put nearly all of the population in the world in the mainland to have a population density like the one we have. This is clearly not the case in any other of the U.S. insular jurisdictions.

But it is also a combination of many complex factors, the basic one being, of course, overpopulation. But we have economic circumstances that make it very difficult to have a really viable economy. There are things such as the following:

It is very difficult, for example, to develop our agricultural system when we have to compete with neighboring islands that do not have to pay Federal minimum wages, that do not have to apply U.S. environmental regulations, that do not have to apply U.S. health, OSHA, regulations, that do not have to use the most expensive bottoms in the world to transport the goods from Puerto Rico to the main market, which is the mainland, and back and forth.

Together with a number of factors, those are what I would say are the basic difficulties inhernt the basic economic infrastructure.

Then, throughout the years we have suffered a number of specific circumstances, like the oil crisis of the 1970's, which brought about the reallocation of the distribution of oil and caused our petrochemical industry to completely disappear. Then we lost thousands of jobs.

The increased access to the U.S. market which has occurred for developing countries as the Nation has liberalized its historic trade laws has also put us in a very difficult situation to compete successfully.

Moreover, the recession in the United States is always felt in Puerto Rico in a more drastic way. For example, our tourism has been deeply affected by it.

So, it is a combination of very, very complicated factors that have led to our unemployment situation. However, I would like to point out two things: If anything has worked in that very dismal picture it is section 936. It is the only mechanism that has allowed us, while jobs are being lost in other sectors, to have a considerable increase in employment in Puerto Rico. We think this framework that I have been describing is in fact the only thing that apparently has been working in Puerto Rico during the last few years in terms of creating employment.

The **CHAIRMAN**. Mr. de Lugo.

Mr. **DE LUGO**. Mr. Chairman, as a neighbor of Puerto Rico let me say, first of all, that 936 in Puerto Rico is seen as a tremendous success story in the Caribbean. It is viewed as that by everyone in the Caribbean.

Second, the biggest problem that Puerto Rico has had has been very well articulated by the resident commissioner, but the biggest problem is the dense population, and let me say that that came home to me.

I just returned from Siberia, a trip with Chairman Udall, and as you know the Soviets are making every effort to get people out into the Siberian area to develop it. They have made every effort over a long period of time. I was impressed by the vastness of the area, it is just huge, and the richness of the area. But with all of this effort, the total population of this vast area is only 2.7 million. And immediately, in my frame of reference, I thought about the small island of Puerto Rico with over 3 million people in that small land area. If Puerto Rico had one one-hundredth of the resources of Siberia, Puerto Rico would really be on top of the world.

Mr. **FUSTER**. Mr. Chairman, if I may add just one little statistic, we have, as I said, from 22 to 23 percent unemployment now; but the best studies that we have been able to conduct lead us to believe that, if we didn't have section 936, our employment now would be closer to 40 percent than 22 percent. I think that gives you an idea of how important section 936 is for us, even in the very dismal circumstances that we are experiencing right now.

The Chairman. Thank you.

Senator Long.

Senator **LONG**. Mr. Fuster, is it necessary to have the same minimum wage for Puerto Rico that we have for the United States? You don't have the same climate for heating and housing to keep people inside in the wintertime that you have on the mainland of the United States. Is it appropriate that the minimum wage in Puerto Rico be the same as it is in the United States?

Mr. **Fuster**. Well, sir, we certainly want our workers to make the best salaries possible. And as a general principle, we would like them to get the minimum wage or even better. But I must admit that there are many people in Puerto Rico who believe that the application, the full application, of minimum wages to Puerto Rico has been a factor that has negatively affected our capacity to create jobs.

The people I represent politically in Puerto Rico have always been very interested in maintaining flexibility along those lines; but I think it is a *fait accompli*. I cannot imagine any kind of political scenario that would make it possible for us to go back to the time when we had a flexible system. Minimum wages have been established in Puerto Rico for a number of years now and, unless you have a way of imagining how we could change, I find it very difficult to believe that we could get the Congress to do it.

Senator **Long**. Well, I am just looking for answers. The thought that occurs to me is that we established a minimum wage because we wanted to assure that working people would not be in poverty. The idea was not to put them out of work.

We are having a similar problem with our trade situation here in the United States. That is why we have the textile bill that is pending on the floor of the Senate right now. We have somewhat parallel problems in our sugar industry. The question that bothers me is, should we really require the same minimum wage for Puerto Rico that we require for the mainland United States?

Suppose someone wants to make an investment. He is deciding where to put a textile plant, or a garment plant. Right next door to Puerto Rico is the Dominican Republic where 85 cents an hour is about the going rate for wages, is it not? You could hire good labor over there.

Mr. **Fuster**. Around that. It is a lot less than the fair minimum wage, to be sure.

Senator **Long**. Now, how on God's green earth do we expect somebody to put his plant—let's say that he has something that is labor-intensive—in Puerto Rico and pay $3.25 an hour when you can just go a little closer to the United States and pay 85 cents an hour?

Mr. **Fuster**. Well, Senator Long, let me suggest that it would take a revision of the whole structure of conditions that affect the Puerto Rican economy because it is not wages alone, it is using the most expensive bottoms in the world to transport our goods, it is dealing with all kinds of very expensive environmental regulations, it is dealing with the energy costs in Puerto Rico. We are 100 percent oil dependent, because we have no coal. We have no other way to produce electricity to run the plants. That is why we believe that a much simpler way to go is to maintain what we have had as a good experience for development, and that is precisely section 936. In other words, in Puerto Rico 936 has worked, and we now have proposals for the future to make it work even better.

I don't think we have to get involved in a very complicated scheme to try to regulate all existing regulations regarding salaries and the environment, et cetera, when we have a simple way out—that is, to give us the opportunity to make a better use of 936, which is basically what we are claiming for now.

Senator LONG. Well, I am not concerned about section 936 and I am planning to vote with you on it. What I am thinking about is the other problem: You have too many people out of work. We do in Louisiana, also. But you are not from Louisiana, you are from Puerto Rico. You came here to tell me about your problems. What I want is some answers. We've got plenty of problems up here—more than we can finance the way it is now—we are looking for answers. I am trying to figure out how we can help you provide some jobs for your people.

Section 936, as I see it, does provides jobs in manufacturing and things like that. However, those tend to be the jobs paying $10 an hour or something like that. But you have a bunch of people who can't get $3.25 an hour.

How can we help you provide jobs for the people who can't even get the minimum wage?

Mr. FUSTER. Well, my only response, Senator, is that some flexibility in that field would probably help; but I don't think it would be substantial. And we do hold an aspiration that as many of our workers should make the best salaries possible. It is a very complicated problem to try to solve it simply along those lines.

I am sorry I can't give you a better answer.

Senator LONG. Thank you.

Mr. de Lugo, I have been around here for 36 years, but I am not familiar with the expression you are using about the "mirror." Would you mind explaining what you mean by that?

Mr. DE LUGO. I think you are setting me up, Senator. [Laughter.] I think I am going to leave now. [Laughter.]

Senator LONG. It would be good if you would explain just what you mean by that. [Laughter.]

Mr. DE LUGO. The Federal tax system is applied to the Virgin Islands as our local tax system. It mirrors completely whatever the Federal tax system is, but it is viewed as a local tax, or a State tax, or a territorial tax. We use the Treasury Department or the Federal forms. The law is applied just as you apply it here on the mainland. So, it is referred to as "the mirror system."

Senator LONG. Basically, you are just saying to a taxpayer, "Here is the same form that you would pay to Uncle Sam?"

Mr. DE LUGO. Right.

Senator LONG. You just give the money to the territorial government instead of to Uncle Sam. Is that it?

Mr. DE LUGO. That is exactly it.

Senator LONG. I see. Thank you.

Mr. SUNIA. Mr. Chairman, may I make one point?

The CHAIRMAN. Mr. Sunia.

Mr. SUNIA. I make the point in my written testimony, but I would touch on it briefly again, and that is, while we have been speaking only on section 936 this morning, I would like to say that in its totality the President's proposed tax package for the territories, so far as American Samoa is concerned, is quite acceptable to us. Our only concern and our only problem is in the area of this particular 936; but the package as a whole, I think, is going to work well for my territory.

Thank you.

The CHAIRMAN. Thank you.

Any other comments?

Mr. BLAZ. Mr. Chairman, I might as well put in my 2 cents' worth also, since these fellows from the Atlantic are taking too much time here. [Laughter.]

Sure, I think the lesson that is obvious to all of us here since we have been here in the Congress is that the tendency and the penchant—in fact, sometimes the obsession—for the Federal Government to treat all of the territories as one may well have to be reexamined, because we are substantially different in our structure and in our location and in our economy.

And in my own case, in the American Territory of Guam, being located where it is in the Pacific Basin, with the enormous amount of emphasis being put out there, we do have an entirely different problem.

Just to reemphasize, I want to associate myself, strongly, one more time with the President's proposal. We want the structure to remain current for a while; but we do want to delink at a future time. And it is very important to us if we were to realize any kind of self-autonomy.

Thank you, sir.

The CHAIRMAN. Gentlemen, thank you very much. I have no more questions.

Now we have two Governors with us, the Honorable Rafael Hernandez Colon and the Honorable Juan Luis, the Governor of Puerto Rico and the Governor of the Virgin Islands, respectively.

Let me thank you both for the many courtesies that have been extended to me when I have been in your areas. I have been there, both places, many times and on occasion have had some dealings with the Government, and needed some private help on occasion. You have been very, very receptive.

Governor Colon.

STATEMENT OF HON. RAFAEL HERNANDEZ COLON, GOVERNOR, COMMONWEALTH OF PUERTO RICO

Governor COLON. Thank you, Mr. Chairman. It is a real pleasure to be here today. Thank you for the opportunity to bring to you the position of the Commonwealth of Puerto Rico on an issue of paramount importance to the well being of 3 million Puerto Ricans.

Section 936 and its predecessors in the Tax Code have been designed to attract investment for the development of Puerto Rico's economy, which is severely handicapped by overpopulation, lack of resources, and affected by Federal legislation which increases our cost of production and transportation.

Section 936 works. It permits the Government of Puerto Rico to forgo taxes on income earned in Puerto Rico in a way that stimulates employment and sustains our economic development. It accounts for at least 30 percent of existing jobs in Puerto Rico. It generates 40 percent of the funds in deposit in the Puerto Rico banking system. It reduces the welfare burden that would otherwise fall on the U.S. Treasury. Compared to our neighbors in the Caribbean, we have achieved, through 936, an economic miracle; but the percapita income of our citizens, $4,096, is still less than one-third the U.S. average and less than half that of the poorest State.

Yet, the administration proposes changing 936 to an untried and considerably less potent alternative, the wage credit, at a time when Puerto Rico is hurting as a result of the fallout of adverse economic factors.

The oil shocks of the early seventies and the change in oil allocation rules cost Puerto Rico thousands of jobs in their refinery industry. The full application of the U.S. minimum wage, environmental, and other costly regulatory requirements, has increased Puerto Rico's cost of labor, production, and transporation, and impeded the ability of Puerto Rico's products to compete in the United States and in foreign countries.

These factors, along with the steep price in energy costs and the substantial lowering of U.S. tariffs that previously had protected Puerto Rican goods coming into the United States created an economic environment in which section 936 prevented a major recession; but, nonetheless, unemployment shot up to 22 percent.

Section 936 is cost effective. The net fiscal costs of 936 to the Treasury is only $376 million, not the $1.7 billion figure used in the tax expenditure analysis in Treasury-II. The net fiscal benefits of Section 936, approximately $880 million, are at least 2.3 times its net fiscal cost to the Treasury.

The administration recognizes, as did the Congress as recently as 1982, that using the Tax Code to enable Puerto Rico to attract U.S. companies is both essential and appropriate. Yet, Treasury-II proposes to replace this income-based incentive which has been used successfully for the past 50 years with an untried wage-based credit of dubious value.

We in Puerto Rico have asked ourselves, and I hope you will ask yourselves, why this new and dangerous experiment with the Puerto Rican economy and the welfare of thousands of Puerto Rican families, when section 936 has been proven effective and its full potential has not yet been tapped?

The Commonwealth of Puerto Rico is committed to maximizing job creation through section 936. I campaigned and won last November on a platform that affirmed that the full potentials of section 936 remained untapped and that the pool of capital created by the interplay of United States and Puerto Rican law could be used more creatively and productively. From the moment I took office in January, my administration has been engaged in a major effort to augment the benefits of 936. We have established financial arrangements that will extend the maturity of 936 finance investments and target those funds into productive real investment in areas such as agribusiness and construction.

For example, we have created a $220 million mortgage trust which will finance at lower than market rates 5,000 housing units per year, thereby solving our housing problem and revitalizing our much depressed construction industry. Through this vehicle we will create 18,000 new jobs, 23 percent in the construction employment—important in Puerto Rico with 22 percent unemployment.

In my inaugural address I committed the earnings of section 936 corporations deposited in the Government Development Bank as a consequence of 936 and our loan law to a strategy of shared regional development for the Caribbean. Financing is now made available on favorable terms for new plants in Puerto Rico, to corporations ready to invest their own funds in twin plants, complementary manufacturing facilities, on other Caribbean Islands. The twin-plant program, therefore, uses section 936 earnings as an incentive for companies to make investments in the Caribbean Basin region.

We now have commitments from 24 section 936 companies to make twin-plant investments, provided section 936 remains unchanged. These projects would generate $114 million of investment, nearly 15,100 direct and indirect jobs in Puerto Rico and its neighboring Caribbean countries, and approximately $58 million annually in total employee compensation in CBI countries.

The CHAIRMAN. Governor, I am going to have to ask you to conclude, because we hold our witnesses to 5 minutes.

Governor COLON. Yes, Senator.

So, this is basically the testimony. Given the chance, we expect, through our policies, to enhance the use of 936 to address our basic problem of unemployment, which is at 22 percent.

Thank you very much.

The CHAIRMAN. Thank you, Governor.

Governor Luis.

[Governor Colon's written testimony follows:]

TESTIMONY
OF
THE HONORABLE RAFAEL HERNANDEZ COLON,
GOVERNOR OF THE COMMONWEALTH OF PUERTO RICO
BEFORE THE
SENATE FINANCE COMMITTEE HEARINGS
ON THE
IMPACT OF THE PRESIDENT'S TAX REFORM PROPOSALS ON THE PROVISIONS RELATING TO THE UNITED STATES' POSSESSIONS AND ITS TERRITORIES

OCTOBER 3, 1985

I appear before you today with an urgent message from the more than 3 million United States citizens who live in the Commonwealth of Puerto Rico and their 2 million brothers and sisters living in the United States. Their message is simple: Keep Section 936 unchanged. This Section and its predecessors in the tax code have been designed to attract investment for the development of Puerto Rico's economy, which is severely handicapped by overpopulation, lack of resources, and affected by federal legislation which increases our costs of production and transportation but does not burden our surrounding Caribbean Basin countries.

Replacing Section 936 of the Internal Revenue Code with a wage credit will devastate our economy, threaten over 90,000 direct jobs in 936 companies, endanger the viability of our banking institutions, deny us access to mortgage money for our homes, and put an immediate halt to our unique and timely opportunity to energize the Caribbean Basin Initiative. Their message must be heard. Repeal of Section 936 would not add revenues to the Federal treasury. Repeal of Section 936 would cause high technology companies to favor foreign countries over Puerto Rico. Repeal of Section 936 would force approximately 50,000 Puerto Ricans to flee to the United States, and trigger a substantial increase in Federal welfare outlays.

Section 936 works. It permits the Government of Puerto Rico to forego taxes on income earned in Puerto Rico in a way that stimulates employment and sustains our economic development. It accounts for at least 30% of existing jobs in Puerto Rico. It generates 40% of the funds on deposit in the Puerto Rico Banking system. It reduces the welfare burden that otherwise would fall on the United States Treasury. Compared to our neighbors in the Caribbean, we have achieved through 936 an economic miracle, but the per capita income of our citizens, $4,096, is still less than one-third the U.S. average and less than half that of the poorest state. Yet, the Administration proposes changing the 936 incentive to an untried and considerably less potent alternative.

Unemployment in Puerto Rico is at 22% because the past ten years witnessed a series of adverse economic factors that no tax incentive could have overcome. The oil shocks of the early 1970's and the change in oil allocation rules cost Puerto Rico thousands of jobs in the refinery industry. The full application of U.S. minimum wage, environmental and other costly regulatory requirements have increased Puerto Rico's costs of labor, production, and transportation, and impeded the ability of Puerto Rico's products to compete in the U.S. and in foreign countries. These factors, along with a steep rise in energy costs and the substantial lowering of U.S.

tariffs that previously had protected Puerto Rican goods coming into the U.S., created an economic environment in which only the preservation of Section 936 can prevent a major recession.

Despite this urgent need for Section 936, the Administration justifies replacing it with a wage credit by asserting that Section 936 costs the Federal Treasury too much in foregone revenues for the amount of benefits it produces. Yet, even the Administration admits in its current tax reform proposal that repeal of Section 936 will not result in any immediate gains to the U.S. Treasury. In fact, according to Treasury revenue estimates, the repeal of Section 936 proposed by the Administration would actually add to U.S. budget deficits in the first two years. Thus, I can only conclude that the heart of the Administration's proposal is based upon its allegation that the benefits derived from Section 936 are inadequate.

In response to this allegation, my primary focus today is on the benefits of Section 936 - not simply to the Commonwealth of Puerto Rico, but also to the United States and the entire Caribbean Basin region. More specifically, my goal is not merely to point out the significant past benefits of Section 936, but rather to demonstrate the elements of a concerted plan to multiply those benefits in both breadth and extent. I assert that the full potential of Section 936 remains untapped, that Section 936 funds can be used creatively to reduce unemployment dramatically in Puerto Rico, and that Section 936 can be the vehicle through which the economic and political stability of the Caribbean Basin region may be ensured.

My Administration commissioned a study by independent economists to compare the costs to the U.S. Treasury of Section 936 with the benefits of retaining Section 936 in its present form. These economists have concluded that the net fiscal cost to the Treasury is only $376 million, not the $1.7 billion figure used in Treasury's tax expenditure analysis. In fact, the net fiscal benefits of Section 936, approximately $880 million, are 2.34 times its net fiscal cost to the Treasury. The study also concludes that repeal of Section 936 and its substitution by a wage credit would increase unemployment in Puerto Rico by at least 61,000.

The Commonwealth of Puerto Rico is committed to maximizing job-creation through Section 936. I campaigned and won last November on a platform that affirmed that unemployment in Puerto Rico could be cut dramatically by more creatively using the pool of capital generated by the interplay of U.S. and Puerto Rico law. Section 936 funds should be directed not so much to the financial system but towards real investment through private industry in our economy. A major element of vital importance to that commitment is the current tax exemption under Section 936 for Qualified Possessions Source Investment Income. This is the income derived by Section 936 corporations from placing their earnings in investments that are exempt from tax under Puerto Rico's

Industrial Incentives Act. Puerto Rico's exemption requires that funds be invested only in eligible depository institutions as defined by regulations.

The earnings of Section 936 corporations now account for over 40% of total deposits in Puerto Rico's commercial banks, and for 25% of the resources of Puerto Rico's savings and loans. In view of these statistics, my administration has been engaged in a major effort to regulate and maximize the use of these Section 936 earnings to promote investment in Puerto Rico and its neighbor Caribbean countries.

In my Inaugural Address, I committed the earnings of Section 936 corporations deposited in the Government Development Bank as a consequence of 936 and our own law to a strategy of shared regional development for the Caribbean. Financing is being made available on favorable terms for new plants in Puerto Rico to corporations ready to invest their own funds in "twin plants" -- complementary manufacturing facilities -- on other Caribbean islands. The twin-plant program therefore uses Section 936 earnings as an incentive for companies to make investments in the Caribbean Basin region.

We now have commitments from twenty-four Section 936 companies to make twin plant investments, provided Section 936 remains unchanged. These projects would generate $114 million of investment, nearly 15,100 direct and indirect jobs in Puerto Rico and its neighbor Caribbean countries, and approximately $58 million annually in total employee compensation in Puerto Rico and Caribbean Basin countries. Six of these commitments involve the creation of plants and jobs in Grenada by pharmaceutical firms. These six commitments represent $4.2 million, or 3.4 times the level of investment already undertaken or committed to under the CBI, and 430 total jobs, or 2.4 times as many jobs as under CBI. Our twin-plant program also allows non-Section 936 companies to make use of Section 936 funds in the Caribbean Basin. For example, commitments in Jamaica would provide factories and housing -- one of that nation's most desperate needs -- by prefabricating units in Puerto Rico and financing them with Section 936 funds. In Dominica, our twin-plant program would make it possible for farmers to sell all of their fruit rather than leaving it to rot on their trees.

Given the chance, we will bring new investments creating thousands of new jobs to the Caribbean Basin where unemployment is the ally of instability -- and a thriving free enterprise can become a bulwark against tyranny. Our program would strengthen the national security of the United States and reduce dramatically the opportunity for subversive influences to overtake the Caribbean. We will call on all our educational institutions, on all our business and managerial skills, on the idealism of the young to assist us in this endeavor.

Our plans to expand the benefits of Section 936 are not limited to Caribbean investments, but extend to major areas of need in the Puerto Rican economy. We have established financial arrangements that will extend the maturity of

936-financed investments, and target these funds into productive real investments in areas such as agribusiness and construction. For example, we have created a $220 million Mortgage Trust which will finance, at lower than market rates, 5,000 housing units per year, thus giving further assistance to our housing problem and revitalizing our much depressed construction industry. Through this vehicle we will create 18,000 new jobs.

Today, 936 funds provide substantial assistance to our housing needs, our construction industry, and, perhaps most importantly, our banking industry. Over 50% of total construction loans and mortgages provided by Puerto Rico's thrifts, which are responsible for fifty percent of all construction loans and 75% of home mortgages in Puerto Rico, are represented by section 936 funds on deposit. The low cost of Section 936 funds has effectively lowered the cost of home financing in Puerto Rico, and otherwise has decreased the cost of borrowing for commercial, industrial and agricultural loans from a pre-1976 rate well above prime to 2/3 of a percentage point below prime. Thus, our banks and thrifts are passing 936 benefits on to customers.

Other current benefits of Section 936 funds, as estimated by our commissioned economic study, include an additional 3,000 jobs in the financial sector derived from Section 936 deposits, and savings of $32 million to the Puerto Rico Government on interest on its debt. This latter savings results from the requirement that 20% of Section 936 funds be invested in Government obligations.

These observations demonstrate that the benefits, both proven and potential, from Section 936 are vast. In contrast, its cost to the U.S. Treasury is negligible. In fact, the Administration's proposal to repeal Section 936 would not increase U.S. tax revenues. According to Treasury revenue estimates, the Administration's proposal actually would add to U.S. budget deficits in the first two years. Moreover, possessions corporations could continue to operate free of U.S. tax by operating through a subsidiary incorporated in a foreign country. However, many of these corporations would not remain in Puerto Rico, as the Treasury Department has acknowledged on numerous occasions. According to our commissioned economics study, as many as 50% of the jobs now existing in Section 936 corporations in Puerto Rico would be removed from Puerto Rico as a result of repealing Section 936 in favor of a wage credit. The vast majority of these jobs would be relocated to the Far East.

Thus, while producing no new tax revenues, the repeal of section 936 would cost Treasury hundreds of millions of dollars annually in increased unemployment and other transfer payments, in response to a severe plunge in the Puerto Rican economy. Migration of unemployed Puerto Rican workers to crowded job markets in the U.S. mainland would add to the fiscal problems of state and local governments.

The Administration's proposal states that the 1982 tax cost of Section 936 per employee was more than $22,000. To be meaningful in predicting the tax cost of Section 936 per employee under comprehensive tax reform, this figure must be adjusted to reflect the reduction in credits attributable to intangible income arising from the TEFRA reforms, the reduction in corporate tax rates in the Administration's proposal, the increased transfer payments that would be required by repeal of Section 936, and the losses from corporate relocation or reincorporation occasioned by repeal. Our commissioned economic study estimates based on these adjustments that repeal of Section 936 in favor of a wage credit would not increase U.S. Treasury net revenues by more than $376 million annually. This is equivalent to a cost based on 81,000 persons directly employed by Section 936 manufacturing companies, as estimated in Treasury's Fifth Report on the Operation and Effect of the Possessions Corporation System of Taxation (1985), of $4,600 per direct employee. When the number of employees is expanded to take account of the indirect employment effects of Section 936, the cost per employee is even less.

When this modest cost per employee is weighed against all the benefits of Section 936, including an estimated average wage per employee of $15,000, the wide range of benefits to the financial sector, additions to the revenues of the Puerto Rican Government, aid to the Puerto Rican construction industry, availability of low-cost housing loans, increased employment, and the vast potential for an innovative and effective Caribbean Basin Initiative, only one conclusion is possible: Section 936 must be preserved. Just as importantly, the consistent challenges to the existence of Section 936 must end. Constant amendment of the tax laws relating to Puerto Rico undermines the confidence and stability that is so essential to our ability to attract new investment and new jobs in Puerto Rico. The current uncertainty itself has the potential to chill our program for investment in the Caribbean.

The Joint Committee on Taxation, in its Tax Reform Options for Consideration by Committee on Ways and Means (September 36, 1985), supports the preservation of Section 936, and so appears to recognize the importance of Section 936 for both economic and national security reasons. However, when I look more closely at the Joint Committee's Tax Reform Options, I realize very quickly that its proposal would substantially alter two elements of Section 936 -- the passive income exemption, and the cost sharing method of accounting for intangibles -- that could jeopardize those economic and national security benefits.

The Tax Reform Option limits the Section 936 credit allowed with respect to passive income to one-half of the U.S. tax on such income. TEFRA has already reduced the amount of passive income that may be received by a 936 company from 50 to 35 percent of its gross income. The consequences of taxing the limited amount of passive income which remains allowable can be easily predicted. All of the substantial benefits I have described today that currently flow to Puerto Rico as a result of the passive income exemption would be drastically reduced, as the incentive for companies to invest Section 936 funds in Puerto Rican investments is reduced. Thus, our $220 million mortgage trust would be in jeopardy, our ability to finance home mortgages and construction loans at favorable rates would be significantly reduced, and the stability of the banking system as a whole would be put at risk.

Perhaps more importantly, a limitation on the passive exemption could deal a fatal blow to Puerto Rico's opportunity to use Section 936 funds to support and significantly bolster the Caribbean Basin Initiative through its twin-plant program. I must emphasize that the pool of funds that forms the basis for our twin-plant initiative would not exist in the Government Development Bank in the absence of the passive income exemption. Thus, the Joint Committee's Option for Section 936 strikes at the very essence of our plan.

The Joint Committee's proposal to repeal the cost-sharing method of accounting for intangibles, enacted just three years ago, could cause a substantial reduction in investment and employment in Puerto Rico. The profit split method is extremely difficult for many companies, particularly those in the electronics industry, to use. More importantly, a 50-50 profit split is inappropriate for companies, such as semiconductor manufacturers, that sell to industrial customers rather than the general public. Their profits do not result from trade marks, trade names or other marketing intangibles but depend almost entirely on the price and reliability of their products. It would be arbitrary and unrealistic to allocate 50 percent of the profits of such companies to marketing intangibles.

No convincing evidence has been presented that the cost sharing method has been abused or utilized by Section 936 companies in contravention of Congressional intent. The reason for repealing cost sharing is not abuse but administrative convenience. The Internal Revenue Service would prefer that a 50-50 profit split be imposed on all companies so that it will not have to determine profits allocable to manufacturing in Puerto Rico on a case-by-case basis. However, this difficulty faced by the Internal Revenue Service in administering the cost sharing method is no different than the difficulty it faces in allocating profits in transactions between U.S. companies and their foreign affiliates under Section 482 of the Internal Revenue Code. The Treasury does not propose to impose mandatory profit split percentages in these foreign transactions.

Ironically, by not providing a realistic alternative to the profit split method, the Joint Committee's Option serves to discourage from operating in Puerto Rico those very companies that provide the greatest economic benefit to the island -- i.e. those companies whose profit is derived largely from tangible costs incurred in Puerto Rico and from manufacturing intangibles. These companies may be able to achieve a better profit split in foreign countries under Section 482 than the 50-50 profit split they would be allowed in Puerto Rico. With the electronics industry, a major employer in Puerto Rico in the 1980's, currently facing difficult economic times, this consideration could become crucial in company decisions on where to locate or relocate manufacturing facilities. Puerto Rico will lose investments and jobs as a result.

On behalf of the people of Puerto Rico, I ask the Congress to give my Administration the opportunity to show how creatively and constructively 936 can be used if left unchanged. We ask Congress to join our alliance for prosperity -- to assist us in earning a new place in the world economy -- and to gain for the United States a new place of honor in the history of the Caribbean.

STATEMENT OF HON. JUAN LUIS, GOVERNOR, TERRITORY OF THE VIRGIN ISLANDS

Governor LUIS. Thank you, Mr. Chairman.

Mr. Chairman and distinguished members of the Senate Finance Committee, I am pleased to have this opportunity to testify on the administration's proposal to reform the mirror income tax system in force in the U.S. Virgin Islands, by which the U.S. Internal Revenue Code serves as our local territorial Tax Code.

I also wish to thank this committee again for its past assistance to the Virgin Islands.

Mr. Chairman, at the outset let me say that I take strong exception and strongly oppose recent suggestions by certain staff members that all of the U.S. possessions be delinked from the mirror system. This suggestion appears to stem from an erroneous assumption that delinkage would simplify the task of drafting comprehensive tax reform legislation.

All territories, however, are not alike, either economically, geographically, or culturally. Thus, while certain U.S. territories have expressed a preference to delink from the mirror system, the Virgin Islands has determined that the existing tax structure, with certain modifications, provides us with the most efficient and fair means to raise revenue for the support of the territorial government. It is efficient, in that it means that the Virgin Islands can use all of the IRS forms, regulations, and precedents, without having to develop our own from scratch. With only 105,000 people, we are simply too small to reinvent the IRS and all of its paperwork.

It is fair, in that it means that U.S. citizens in the Virgin Islands will file the same IRS form 1040 as their counterparts on the mainland, and, within defined limits, pay the same level of tax.

In short, despite certain problems which can be resolved and improvements which can be made, the mirror system has basically served the Virgin Islands well since it was first established in 1921.

With this in mind, I am pleased to note that the Virgin Islands has been conducting beneficial discussions with the Treasury Department over the past 2 years regarding certain reforms in the mirror system.

I am also pleased to note that the administration recognizes the difference between the territories and agrees that the tax system suited to one is not necessarily suitable for the other U.S. territories.

In brief, the Virgin Islands strongly supports the administration's proposed changes in the mirror system with respect to the taxation of individuals. By treating the United States and the Virgin Islands as domestic to each other, qualified by appropriate tax administration and coordination provisions, the administration proposal will eliminate many of the inequities of existing law as well as strengthen the ability of the Virgin Islands Bureau of Internal Revenue to enforce the territory's income tax laws.

On the other hand, the Virgin Islands strongly opposes certain aspects of the administration proposal related to the taxation of corporations.

In particular, the Virgin Islands opposes the proposed amendment of section 28(a) of the Virgin Islands Revised Organic Act, which would subject the Virgin Islands source income of corporations legally resident in the territory to direct U.S. tax for the first time.

First, this aspect of the administration proposal would unilaterally alter longstanding principles that have successfully governed the tax relationship between the United States and the Virgin Islands.

Second, it would inhibit the Virgin Islands' ability to achieve economic self-sufficiency and future economic growth.

And third, these significant losses to the Virgin Islands would not be counterbalanced by any significant revenue gain to the United States.

While the administration has proposed substituting the inhabitant rule with a wage credit patterned after the proposal for Puerto Rico, the Virgin Islands joins Puerto Rico in opposition to the wage-credit substitute. The administration proposal would accord many existing investments in the Virgin Islands less favorable tax treatment than under current law and would cause many companies to move out of the Virgin Islands. Indeed, the mere existence of the administration proposal has caused a number of U.S. investors to delay or cancel plans for establishing manufacturing operations in the territory.

Finally, I wish to note the importance of eliminating the arbitrary restrictions on foreign investment in the Virgin Islands. I am pleased to note that Treasury has not been able to find any tax policy or technical objections to permitting the Virgin Islands to reduce the Virgin Islands' tax liability of a non-United States-controlled Virgin Islands corporation on its Virgin Islands source income.

My administration looks forward to working with the members and staff of this committee to develop our proposal to encourage foreign investment in the Virgin Islands, without tax or revenue consequences to the United States.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Governor.

[Governor Luis' written testimony follows:]

Statement of

Juan Luis, Governor
U.S. Virgin Islands

Hearings on Tax Reform
October 3, 1985

Committee on Finance
United States Senate
Washington, D.C.

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE SENATE FINANCE COMMITTEE, I am pleased to have this opportunity to testify on the Administration's proposal to reform the income tax system in force in the U.S. Virgin Islands and the tax relationship between the United States and the Virgin Islands (the "Administration Proposal"). The Administration Proposal reflects a substantial effort to make the Virgin Islands income tax system simpler and fairer, while encouraging economic growth in the Territory.

The Administration Proposal, however, is only partially successful in achieving its stated goals with respect to the Virgin Islands. The Virgin Islands strongly supports the Administration's proposed changes with respect to the taxation of individuals. By treating the United States and the Virgin Islands as domestic to each other, qualified by appropriate tax administration and coordination provisions, the Administration Proposal will eliminate many of the inequities of existing law, as well as strengthen the ability of the Virgin Islands Bureau of Internal Revenue to enforce the Territory's income tax laws.

On the other hand, the Virgin Islands strongly opposes certain aspects of the Administration Proposal related to the taxation of corporations. In particular, the Virgin Islands opposes the proposed amendment of Section 28(a) of the Virgin Islands Revised Organic Act which would subject the Virgin Islands source income of corporations legally resident in the

Territory to direct U.S. tax for the first time. First, the Administration Proposal would unilaterally alter long-standing principles that have successfully governed the tax relationship between the United States and the Virgin Islands. Second, it would inhibit the Virgin Islands ability to achieve economic self-sufficiency and future economic growth. And third, these significant losses to the Virgin Islands would not be counterbalanced by any significant revenue gain to the United States. Indeed, certain of the proposed changes with respect to corporations would violate the agreement in principle reached just last year between the Virgin Islands Government and the U.S. Treasury Department on comprehensive reform of the U.S.-Territorial tax relationship. Moreover, the Administration Proposal would accord the Virgin Islands with less favorable tax treatment than that which the United States has proposed for certain of the non-U.S. trust territories in the Pacific.

For purposes of clarity, my statement is divided into three sections. First, I will provide a brief statutory overview of the Virgin Islands' income tax system and the existing tax relationship between the United States and the Virgin Islands. Second, I will summarize the Administration Proposal and analyze its impact on both individuals and corporations in the Virgin Islands. And, third, I will present the Virgin Islands proposal for Territorial tax reform.

I. The Mirror System of Taxation: A Statutory Overview

In 1921, Congress established a separate taxing structure for the U.S. Virgin Islands by requiring the Virgin Islands to administer the income tax laws of the United States as the Virgin Islands territorial income tax.[1] In 1954, Congress enacted the Virgin Islands Revised Organic Act which governs the federal relationship between the Virgin Islands and the United States. Section 28(a) of the Revised Organic Act clarifies the tax relationship between the two taxing jurisdictions and allocates taxing responsibilities with respect to persons who are "inhabitants" of the Virgin Islands, In particular, Section 28(a) provides:

> [Inhabitants of the Virgin Islands] shall satisfy their income tax obligations under the taxing laws of the United States by paying their tax on income from all sources both within and without the Virgin Islands into the Treasury of the Virgin Islands.

48 U.S.C. §1642.

Thus, under Section 28(a) of the Revised Organic Act, all Virgin Islands persons, including (1) individual residents of the Virgin Islands, (2) Virgin Islands corporations, and (3)

1/ Naval Appropriations Act of 1922, 48 U.S.C. §1397. The effect of the Naval Appropriations Act was to "mirror" the U.S. Internal Revenue Code ("Code") in the Virgin Islands, whereby the words "Virgin Islands" are substituted for the words "United States" (hereinafter the "Mirror Code" or "Mirror System of Taxation"). Under the Virgin Islands Mirror Code, the Virgin Islands and the United States constitute two separate taxing jurisdictions, each foreign to the other.

qualified U.S. corporations which have a significant presence in the Virgin Islands, satisfy their U.S. income tax obligations by paying tax on their worldwide income to the Virgin Islands (hereinafter the "inhabitant rule"). In order to prevent tax sheltering of U.S. source income and other potential abuses, Congress added Section 934(a) to the Internal Revenue Code, which prohibits the Virgin Islands from granting relief, directly or indirectly, from Virgin Islands income tax. At the same time, however, the Congress established exceptions to this general prohibition in order to encourage legitimate, desirable and needed investment in the Virgin Islands. Under Section 934(b) of the Code, the Virgin Islands is permitted to subsidize income taxes on non-U.S. source income of a U.S. or a Virgin Islands corporation that derives at least 80 percent from V.I. sources and at least 65 percent[2] of its gross income from the active conduct of a trade or business in the Virgin Islands ("Section 934(b) corporations"). Similarly, under Section 934(c), the Virgin Islands is permitted to subsidize the income tax of an individual citizen of the United States who is a bona fide resident of the Virgin Islands during the entire taxable year.[3]

2/ The 65 percent active trade or business test was increased from 50 percent by the Tax Equity and Fiscal Responsibility Act of 1982.

3/ Subsection (f) of Section 934 provides an additional exception for foreign sales corporations.

II. The Administration Proposal

A. Taxation of Individuals

1. Current Law

Under current law, a resident of the Virgin Islands is not required to file a U.S. income tax return or pay withholding or estimated tax to the United States. Instead, a V.I. resident satisfies his U.S. income tax obligations by filing a Virgin Islands income tax return and paying tax to the V.I. on his worldwide income. The Virgin Islands administers the Mirror Code income tax with respect to its own residents, but the Virgin Islands does not receive all information returns related to such individual's non-V.I. source income. The Internal Revenue Service ("IRS") can send to the Virgin Islands information returns for individuals who report a V.I. address, but has no way of identifying the information returns of V.I. residents who do not report a V.I. address. The Virgin Islands is thus at a disadvantage, relative to the United States, in ensuring the reporting of income derived by a V.I. resident from sources outside of the Territory.

In addition, the United States is treated as foreign to the Virgin Islands under current law, with the consequence that certain tax benefits are denied to V.I. residents. For example, a V.I. resident may not join with a U.S. resident to form a Subchapter S corporation. Similarly, a V.I. resident may not claim an exemption for a dependent resident in the United States, nor file a joint return with a spouse residing in the U.S.

At the same time, an individual who is a resident or citizen of the United States, but who is not a resident of the Virgin Islands, is treated as a non-resident alien for purposes of V.I. income tax laws. This treatment of U.S. citizens and residents as foreign results in several harsh tax consequences. For example, the standard deduction, or zero bracket amount, does not apply. The U.S. resident's V.I. business losses cannot be used to offset V.I. source non-business income. And married individuals cannot file a joint return and are therefore subject to the higher rates applicable to a married individual filing separately.

2. Administration Proposal - Individuals

The Administration Proposal would eliminate the inequities inherent in treating an individual resident of one jurisdiction as a non-resident alien in the other (i.e., as foreign) by applying rules of "qualified domestic reciprocity" for purposes of determining the income tax liability of such person to each respective jurisdiction. Specifically, the Administration Proposal would treat the Virgin Islands as part of (or domestic to) the United States for the purpose of determining an individual's U.S. income tax liability and would treat the United States as part of (or domestic to) the Virgin Islands for the purpose of determining Virgin Islands income tax liability.

The proposed changes also include the following income allocation rules: An individual qualifying as a bona fide Virgin

Islands resident on the last day of the taxable year (determined under general principles under the Internal Revenue Code) would continue to pay tax to the Virgin Islands under the Mirror Code on his worldwide income and would have no final tax liability for such year to the United States. Any taxes withheld in the United States from payments to such an individual, and any estimated tax payments made by such an individual to the United States, would be covered into the Virgin Islands Treasury and would be credited against the individual's Virgin Islands tax liability. A Virgin Islands resident deriving gross income from sources outside of the Virgin Islands would list all items of such income on an attachment to his Virgin Islands return. Information contained on these attachments would be compiled by the Virgin Islands Bureau of Internal Revenue and transmitted to the IRS. Transmission of this information to the IRS will permit full matching of U.S. information returns with V.I. tax returns and thus facilitate compliance with V.I. tax laws.

A citizen or resident of the United States (other than a bona fide Virgin Islands resident) deriving income from the Virgin Islands would compute his tax liability to the Virgin Islands for the taxable year as a percentage of his U.S. tax liability on his worldwide income. The percentage will be equal to the share which the taxpayer's adjusted gross income derived from Virgin Islands sources comprises in relation to his worldwide adjusted gross income. Such an individual would file identical income tax returns with both the United States and the Virgin Islands. The individual's Virgin Islands tax liability would be credited against his U.S. tax liability. Thus, while the Virgin Islands would derive all tax revenues on such a person's Virgin Islands source income, his overall tax liability (*i.e.*, U.S. and V.I. tax liability combined) would be unaffected.

In the case of a joint return filed by a couple where only one spouse qualified as a bona fide resident of the Virgin Islands, resident status of both spouses would be determined by reference to the status of the spouse with the greater adjusted gross income for the taxable year. Rules for the payment to the Virgin Islands of estimated taxes by a U.S. resident would also be provided.

In addition, the Administration Proposal provides that consideration would be given to permitting the Virgin Islands to reduce the V.I. tax liability of certain foreign persons in order to stimulate additional economic activity in the Territory. This proposal is discussed in greater detail below.

3. Analysis - Individuals

The Administration Proposal incorporates substantially all of the reforms with respect to the taxation of individuals originally sought by the Virgin Islands during previous negotiations with the Treasury Department. The application of "qualified domestic reciprocity" to determine income taxation rights and responsibilities, with these clearly defined income allocation rules, is the product of those negotiations. This approach effectively eliminates many of the complexities and inequities otherwise inherent under the Mirror Code.

The Administration Proposal preserves for the Virgin Islands the revenue advantages of current law and significantly strengthens the ability of the Virgin Islands to enforce its tax laws. It also provides potential new sources of economic activity in the Territory by permitting reduced taxation of foreign persons. In short, the provisions relating to taxation of individuals constitute long overdue reform and should be enacted.

B. Taxation of Corporations

1. Current Law

Under current law, a V.I. corporation or a U.S. corporation "inhabitant" in the Virgin Islands satisfies its U.S. income tax liability by paying tax on its worldwide income to the Virgin Islands. In order to attract investment in the Virgin Islands and to achieve the necessary broadening of its economic base, the Virgin Islands has adopted a local industrial incentive program for qualified corporations which meet the gross income tests of Section 934(b),[4] as well as certain local criteria (hereinafter the "934(b) Industrial Incentive Program"). In general, under the 934(b) Industrial Incentive Program a U.S. or V.I. corporation which invests substantial capital and employs Virgin Islands residents is eligible for rebates of up to 90 percent of income taxes paid and exemptions from various other local taxes.

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[4] Code Section 934(b) requires that a V.I. or U.S. corporation must derive at least 80 percent of its gross income from V.I. sources and at least 65 percent of its gross income from the active conduct of a trade or business in the V.I. in order to be eligible for the local industrial incentive program.

A V.I. corporation or a U.S. corporation inhabitant in the Virgin Islands is required only to file a Virgin Islands return on its worldwide income. A U.S. corporation, not inhabitant in the Virgin Islands but which derives income from the active conduct of a trade or business in both the Virgin Islands and the United States, must file both a V.I. and a U.S. return.

Under Section 28(a) of the Revised Organic Act, a Virgin Islands corporation satisfies its U.S. tax obligations by paying tax on its worldwide income, including U.S. source income,[5] to the Virgin Islands. However, dividends received by a U.S. shareholder which are paid out of the V.I. earnings of a Virgin Islands corporation are not eligible for a dividends-received

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5/ The inhabitant rule thus allows the Virgin Islands to tax the U.S. source income of a qualified inhabitant corporation. The legislative history of the 1954 Revised Organic Act makes clear that this provision was specifically enacted as a revenue measure, i.e., it was intended to allow the Virgin Islands to increase its income tax revenues in order to operate its local government and to avoid having to petition Congress for ad hoc annual appropriations. Because Section 934 expressly prohibits the Virgin Islands from subsidizing the U.S. source income of any V.I. inhabitant, Section 28(a) does not allow U.S. persons to escape tax on U.S. source income. Under the Mirror Code, full tax on such income is merely paid to the Virgin Islands Treasury rather than the U.S. Treasury.

deduction under Code Section 243, and thus are taxable by the U.S. at regular U.S. rates. In other words, notwithstanding Section 28(a), a V.I. corporation, like any other foreign corporation, is exempt from U.S. tax only to the extent that its earnings are not repatriated to the U.S.

V.I. corporations (as foreign corporations) are liable for the U.S. 30 percent withholding tax on passive or investment income earned by foreign corporations. However, under Code Section 881(b), a V.I. corporation is treated as domestic to the U.S. for the purposes of this tax (and thus is not subject to such 30 percent withholding tax) if (1) less than 25 percent in value of its stock is owned by foreign persons, and (2) at least 20 percent of its income is derived from sources within the Virgin Islands. The application of the 30 percent withholding tax to income earned by non-qualified V.I. corporations is intended to prohibit the Virgin Islands from becoming a tax-free conduit for unrestricted foreign investment in the United States.

Similarly, Code Section 957(c) provides that a Virgin Islands corporation shall not be considered a controlled foreign corporation (the Subpart F income of which would otherwise be taxed currently to its controlling shareholders) if at least 80 percent of its gross income is derived from Virgin Islands sources and 50 percent of its gross income is derived from the active conduct of a trade or business in the Virgin Islands. Section 957(c) operates as a corollary to the inhabitant rule which provides that a V.I. corporation satisfies its U.S. income tax liability by paying tax on its worldwide income, including Subpart F-type income, to the Virgin Islands. The effect of this provision is to prevent double taxation of such income by both the V.I. and the U.S.

A U.S. corporation which is an inhabitant of the Virgin Islands[6] is also exempt from U.S. tax on its worldwide income. Unlike a V.I. corporation, however, a U.S. corporation inhabitant in the Virgin Islands is considered "domestic" to the U.S. and thus dividends received by a U.S. shareholder from a qualified U.S. corporation are eligible for a Section 243 dividends-received deduction. Thus, the income of a U.S. corporation which is an inhabitant of the Virgin Islands is exempt from current U.S. tax and may be repatriated to a U.S. corporate shareholder tax-free.

6/ In Revenue Ruling 80-40, the IRS indicated that a U.S. corporation would be considered an "inhabitant" of the Virgin Islands if it (1) meets the gross income tests under Code Section 934(b), (2) conducts all significant business operations in the Virgin Islands, (3) holds all shareholder meetings in the V.I., and (4) has officers that are V.I. residents.

2. Administration Proposal

Under the Administration Proposal,[7] the inhabitant rule under Section 28(a) of the Revised Organic Act would be amended so that U.S. source income of a V.I. corporation or a U.S. corporation inhabitant in the Virgin Islands would be subject to U.S. tax (rather than V.I. tax) for the first time. In addition, elimination of the inhabitant rule for corporations would mean that a U.S. corporation deriving substantially all of its income from V.I. sources would be subject to U.S. tax on both its V.I. and U.S. earnings. A V.I. corporation, in addition to a U.S. corporation, that derives income from the active conduct of a trade or business in both the Virgin Islands and the United States would now have to file a tax return in both jurisdictions.

In lieu of the inhabitant rule which exempts qualified U.S. corporations from current U.S. tax, the Administration Proposal would provide a permanent wage credit for such U.S. (but not V.I.) corporations operating in the Territory. Under the Administration plan, a U.S. corporation could elect a wage credit equal to 60 percent of wages, up to the Federal minimum wage amount, plus 20 percent of such wages paid above the Federal minimum wage amount, subject to an overall wage cap per employee

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7/ In numerous instances, the Administration Proposal does not clearly articulate the purpose or mechanism of change, thereby leaving the V.I. with a wide range of possible outcomes, each with a distinctive impact on the economy.

of four times the Federal minimum wage amount.[8] Corporations electing the wage credit would be required to reduce their otherwise allowable deduction for wages paid by the amount of the wage credit claimed. Moreover, the credit would be limited to firms engaged in manufacturing (but not service industries such as hotels) in the Virgin Islands.

The wage credit may be used to offset the U.S. tax on any income, including U.S. source income, of the U.S. corporation operating in the Virgin Islands or any of its affiliated corporations filing under a consolidated return. The credit would be non-refundable, but could be carried forward for 15 years. Corporations electing the credit would not be entitled to claim a foreign tax credit for taxes paid to the Virgin Islands, but would be allowed instead a deduction for such taxes. In addition, dividends paid by U.S. corporations electing the wage credit would continue to be eligible for a Section 243 dividends-received deduction and thus could repatriate such dividends back to a U.S. parent corporation tax free. Under the "grandfather provisions" included in the Administration Proposal, a U.S. corporation operating in the Virgin Islands as an inhabitant corporation would be allowed to elect to retain existing tax

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8/ At the present annual minimum wage amount of $6,968, and with a 33 percent corporate tax rate included in the Administration Proposal, the minimum net credit would be $5,602 per employee (67 percent of the maximum gross credit of $8,362 per employee).

benefits for the first five years after enactment of the Administration Proposal in lieu of the wage credit. However, the meaning of existing tax benefits under the Administration Proposal remains ambiguous.

The Administration Proposal would amend the anti-conduit provisions of Section 881(b) to require that 65 percent of a V.I. corporation's income be effectively connected with a V.I. trade or business in order to continue to be exempt from the U.S. 30 percent withholding tax on any investment income earned in the U.S. The Administration Proposal would also repeal Code Section 957(c), thus eliminating the deferral of U.S. tax on any Subpart F income earned by a V.I. corporation that would otherwise qualify as a controlled foreign corporation. On the other hand, in order to help attract foreign investment to the Virgin Islands, the Administration has proposed its willingness to consider authorizing the Virgin Islands to reduce or rebate the tax liability of certain foreign persons with respect to income derived from Virgin Islands sources.

3. Analysis - Corporations

a. U.S. Investment in the Virgin Islands

The Virgin Islands Section 934(b) Industrial Incentive Program under existing law has generated significant employment and economic activity in the Virgin Islands. Indeed, the economic activity generated by the program has exceeded by severalfold the cost of any income tax subsidy provided. In particular, qualifying Section 934(b) corporations during the period 1976-1980:

(1) were directly responsible for approximately 25 percent of all private non-agricultural employment in the Virgin Islands;

(2) generated annual direct tax revenue and derivative spending, including direct and overhead operating expenditures, in the Virgin Islands ranging from $67.3 million to $129.5 million;

(3) received annual aggregate income tax subsidies ranging from $18.6 million to $32.8 million;[9] and,

(4) provided direct economic benefits in the Virgin Islands ranging from $2.90 to $7.00 per $1.00 of income tax subsidy.

The Territory's 934(b) Industrial Incentive Program has contributed significantly to economic growth in the Virgin Islands, as well as to the diversification of the Territory's economic base. In particular, the program is responsible for the development of the Territory's heavy industries, such as oil refining and alumina processing, as well as light manufacturing industries, such as watch manufacture and textiles. Additionally, a substantial proportion of the Territory's hotel employment, recreational firms and critically important local

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9/ Using the Treasury Department's narrow evaluation method, a tax subsidy ranging from 23 to 57 cents per $1.00 of wages paid resulted. Since most of the Section 934(b) corporations operate as V.I. corporations and these would not be subject to current U.S. tax on their V.I. earnings, even without regard to the inhabitant rule, most of the cost of the Section 934(b) Industrial Incentive Program is borne by the Virgin Islands and not by the United States.

transportation and communications infrastructure is supported by the program. At the same time, there is no evidence to suggest that Section 934(b) corporations are utilizing existing law to shift income to the Virgin Islands or to shelter U.S. source income from U.S. tax.[10]

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[10] Notwithstanding the basic effectiveness of the current U.S.-Virgin Islands tax relationship and the 934(b) Industrial Incentive Program, the Virgin Islands entered into discussions with the Treasury Department in 1983 to seek technical reforms in the Mirror Code in order to eliminate certain technical problems and inequities with respect to the taxation of both Virgin Islands individuals and corporations. The guiding principles under which these discussions were conducted were: (1) any changes in the existing mirror system of taxation should be revenue neutral and (2) the effective incentive level under the Virgin Islands 934(b) Industrial Incentive Program for corporations should remain unchanged or be enhanced.

As a result of these discussions, agreement in principle was reached in 1984 on certain changes in the Virgin Islands Mirror System of Taxation that would have benefited both the Virgin Islands and the United States. Unfortunately because agreement was not reached until late in the legislative year, the V.I. tax reform package could not be enacted as part of the 1984 Tax Reform Act. It had been the Virgin Islands' intention to pursue these proposed changes in the current legislative year. That intention -- and the package of tax reform freely negotiated and agreed to by the Virgin Islands Government and the U.S. Treasury Department last year -- has been superseded by the Administration's present effort to enact comprehensive tax reform. While the current Administration Proposal incorporates substantially all of the changes agreed to last year with respect to taxation of individuals, the Administration Proposal unilaterally renounces fundamental principles of Federal-Territorial policy with respect to the taxation of corporations, discussed below, which the Treasury Department reaffirmed only last year.

Moreover, there is a bill presently pending in Congress

Footnote 10 continued on next page

By repealing the inhabitant rule and thus subjecting U.S. corporations qualifying for Section 934(b) benefits to direct U.S. tax on their V.I. source income for the first time, the Administration Proposal would (1) radically alter long-standing principles governing the tax relationship between the Virgin Islands and the United States, (2) drastically inhibit the Territory's only industrial incentive program to attract U.S. investment and create jobs, and (3) damage the V.I.'s ability to achieve economic and financial self-sufficiency.[11] At the same time, the Administration Proposal would not result in any significant revenue gain for the U.S. For example, Section 934(b) firms participating in a 1979 survey were asked to identify other locations considered before establishing in the Virgin Islands. Of the 29 respondents, only 3 had considered settling on the U.S. mainland, 12 considered foreign jurisdictions, mainly in the Caribbean and 13 considered other

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Footnote 10 continued from previous page
to approve a Compact of Free Association negotiated between certain of the trust territories in the Pacific and the United States. The Compact, if approved, would permit non-U.S. territories to enjoy the benefits of the U.S. income tax system as it existed in 1980, including the Possessions Tax Credit mechanism. Future restriction of such benefits would be made significantly more difficult under the Compact. Long-standing Federal policy requires that U.S. flag territories be treated at least no less favorably than non-U.S. jurisdictions.

11/ Further, the proposed transition provisions may raise constitutional issues with respect to companies that have contracted with the Virgin Islands for the benefits of the existing Section 934(b) Industrial Incentive Program.

U.S. possessions and off-shore areas. There is a very low probability that these corporations would relocate to the U.S. mainland in the absence of their current or equivalent tax benefits.

While under the Administration Proposal a U.S. corporation electing the wage credit could reduce its U.S. tax liability on its V.I. earnings by the amount of such credit, as well as continue to repatriate any after-tax earnings back to its U.S. parent tax-free utilizing the Section 243 dividends-received deduction, the Administration Proposal would accord many existing investments in the Virgin Islands significantly less favorable tax treatment than under current law and could cause many Section 934(b) corporations to move out of the Virgin Islands. Moreover, the mere existence of the Administration Proposal to alter the U.S.-Territorial tax relationship has caused a number of U.S. investors to delay or cancel plans for establishing manufacturing operations in the Virgin Islands.

The wage credit provides an ineffective tax incentive which is biased in favor of labor-intensive industries at the expense of capital-intensive industries. In addition, the credit is apparently not available to offset U.S. tax on non-manufacturing V.I. investments, such as hotels or other tourism-related industries. Because of its size, geographical limitations and relatively high wage structure, labor intensive manufacturing is neither seriously feasible nor always desirable in the Virgin

Islands. Thus, it is only under uncertain circumstances, unrelated to wage costs, that a U.S. manufacturing firm would be attracted by a wage credit to locate in the Virgin Islands. In short, the Administration Proposal is no substitute for current law in terms of providing effective incentives for U.S. investment in the Virgin Islands.

b. Foreign Investment in the Virgin Islands

The proposed elimination of the Section 957(c) exemption of Virgin Islands corporations from the Subpart F rules is unnecessary. Since under current law a Virgin Islands corporation would have to meet the gross income tests of both Section 934(b) and Section 957(c) in order to qualify for both V.I. tax subsidies as well as exemption from U.S. tax under Subpart F, a Virgin Islands controlled foreign corporation would, as a practical matter, be able to earn only de minimus amounts of Subpart F-type income.[12] Since the Code already exempts a

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12/ Subpart F income generally includes (1) income derived from the insurance of U.S. risks and (2) foreign base company income (generally including certain foreign source investment income, sales and service income, and most types of shipping income).

As a practical matter, invariably most, if not all, of the Subpart F-type income that could be earned by a controlled V.I. corporation would be non-V.I. source income. For example, under Section 862(a)(7) of the Mirror Code, "underwriting income other than that derived from sources within the Virgin Islands" is generally treated as foreign source income. Thus, unless underwriting income is derived from the insurance of Virgin Islands risks, such income will be considered foreign source income.

Footnote 12 continued on next page

controlled foreign corporation which earns de minimus amounts of Subpart F income from the Subpart F rules, there appears to be no practical reason to support the proposed change.

On the other hand, the proposal to permit the Virgin Islands to reduce or subsidize (1) the V.I. tax liability of a non-U.S. controlled Virgin Islands corporation on V.I. and foreign source income without regard to the gross income tests under Section 934(b) (together with similar proposals with regard to foreign individuals and other entities), and (2) the V.I. 30 percent withholding tax on certain investment income earned by non-U.S. controlled persons would eliminate a significant constraint on foreign investment in the Virgin Islands. By doing so, the Virgin Islands could seek to attract foreign capital for V.I. businesses, as well as encourage the development of a new financial services industry (generating Subpart F-type income for non-U.S. controlled persons) that complements the existing foreign sales corporation industry in the Virgin Islands.

Footnote 12 continued from previous page

Similarly, under Section 861(a) of the Mirror Code, only limited categories of investment income, such as interest received from persons in the Virgin Islands (other than banks), dividends received from most Virgin Islands corporations and from foreign corporations earning at least half of their income from a Virgin Islands trade or business, and rentals or royalties from property located in the Virgin Islands, are treated as Virgin Islands source income. Under Section 862(a) of the Mirror Code, most other investment income is treated as foreign source income.

The Virgin Islands would thus be able to stimulate foreign investment in the Territory by eliminating the current restrictions on non-U.S. controlled persons from earning non-V.I. and non-U.S. source income and by allowing the Virgin Islands to reduce its prohibitive 30 percent withholding tax on any Virgin Islands or non-U.S. source investment income earned by non-U.S. controlled persons. The new incentives for foreign investment would not be at the expense of U.S. revenues, since they would not apply to a controlled corporation, as defined in Section 957 of the Code, unless the rules of Code Section 934(b) are met. In addition, the ability to reduce or rebate taxes for non-U.S. persons would be restricted to income other than U.S. source income.

The proposal to allow the Virgin Islands to attract foreign investment would be consistent with the authority of other U.S. possessions which are not subject to the Mirror System of Taxation. In addition, it would be consistent with the U.S. system of tax treaties with other nations which provide for reduction in the 30 percent withholding tax on investment income of non-residents. In conjunction with the Administration's proposed modification of Section 881(b), the proposal could not be used to establish the Virgin Islands as a conduit to channel foreign investment into and out of the United States tax-free. In short, the proposal would permit the Virgin Islands to attract new investment without tax or revenue consequences to the U.S.

III. Virgin Islands Proposed Tax Reform Alternative

Rather than attempting to restrict or eliminate a tax incentive program which is benefiting the Virgin Islands without harming the United States, any tax reform focus with regard to the Virgin Islands should be more carefully tailored to meet the objectives stated in the Administration Proposal -- "fairness, simplicity and growth":

-Fairness- Fairness dictates that the U.S. must continue to treat the Virgin Islands and Virgin Islands corporations more favorably than foreign jurisdictions and foreign corporations.

-Simplicity- Extending the concept of "qualified domestic reciprocity" to corporations, as well as to individuals, will provide a unified set of tax rules and simplify the otherwise complex Mirror System of Taxation.

-Growth- The V.I. has explicitly chosen a self-help approach to foster local private sector economic growth in lieu of federal operating grants. A clearly defined and consistent tax relationship with the U.S. is a pre-condition for necessary U.S. investment in the Virgin Islands.

General Principles

The Virgin Islands proposes that the goals of fairness, simplicity and growth can be achieved by amending the current Mirror Code and the statutes relating to Virgin Islands income taxation (primarily Section 28(a) of the Revised Organic Act and Section 934 of the Internal Revenue Code) as follows:

1. To meet the goals of fairness and simplicity, reform the mirror system by treating Virgin Islands persons, including both individuals and corporations, as domestic to the United States and by treating United States persons, including both individuals and corporations, as domestic to the Virgin Islands, while retaining the ability of the Virgin Islands to subsidize V.I. and foreign source income. In addition, provide income allocation rules that are revenue neutral and parallel existing law. One result of this approach would be to permit a U.S. shareholder of a Virgin Islands corporation to be eligible for a Section 243 dividends-received deduction for dividends paid out of Virgin Islands source income, thus eliminating any disincentive to investment in the Virgin Islands resulting from U.S. taxation on the repatriation of Virgin Islands earnings. Another result would be to clarify that the Virgin Islands is part of the United States for purposes of the non-application of the premium excise tax imposed by Code Section 4371 on insurance policies issued by foreign insurers on U.S. risks, thus allowing expansion of the Virgin Islands insurance industry.

2. To address the objective of growth, provide for two types of incentive programs of tax reduction, one similar to the existing Section 934(b) Industrial Incentive Program for investment from the United States and a new program to promote investment in the Virgin Islands from abroad. This may be accomplished by permitting the Virgin Islands to subsidize the

Virgin Islands tax liability of a non-U.S. controlled Virgin Islands corporation on Virgin Islands and foreign source income and providing similar rules for foreign individuals and entities.

The proposal has the following advantages:

- Eliminates Mirror System inequities while retaining the same basic tax code.
- Retains separate administration of the tax code in the Virgin Islands by the Virgin Islands Bureau of Internal Revenue and improves the ability of the Bureau of Internal Revenue to coordinate administration with the Internal Revenue Service.
- De minimus revenue impact on either the United States or Virgin Islands treasuries as compared to existing law.
- Maintains and improves existing tax incentives for V.I. investment.
- Reduces disincentives to invest in the Virgin Islands as compared to other foreign jurisdictions by treating the V.I. as part of the U.S. for tax purposes only.

- Provides new opportunities for investment in the Virgin Islands financial services sector with no tax consequences to the U.S. Treasury, while offering additional employment and revenue benefits for the Territory.
- Aids tax administration by simplification of tax rules and thereby eliminates opportunities for unintended tax avoidance under the existing mirror system.

Coordination Rules

Under this proposal, tax coordination provisions would be required to allocate tax revenues between the United States and the Virgin Islands in a neutral fashion. Two suggested sets of rules are as follows:

1. With respect to individuals, the Virgin Islands endorses the income allocation rules proposed by the Administration. Thus an individual qualifying as a bona fide resident of the Virgin Islands would continue to pay tax to the Virgin Islands under the Mirror Code on his worldwide income and would have no final tax liability to the United States. An individual resident of the United States (other than a bona fide Virgin Islands resident) deriving income from the Virgin Islands

would compute his tax liability to the Virgin Islands as a percentage of his U.S. tax liability on his worldwide income. The percentage would be equal to the share which the taxpayer's adjusted gross income derived from V.I. sources comprises in relation to his worldwide adjusted gross income.

2. With respect to corporations, a Virgin Islands corporation would continue to pay tax on its worldwide income to the Virgin Islands. A Virgin Islands corporation earning any U.S. source income would be subject to U.S. tax on such income, but such tax liability would be offset by a tax credit for any V.I. tax paid. A U.S. corporation legally resident in the Virgin Islands would pay tax on its V.I. source income to the Virgin Islands and tax on its U.S. and non-V.I. source income to the United States.

It is also important to note what the Virgin Islands proposal does not suggest:

- The proposal does not suggest that the Virgin Islands be able to serve as an unintended conduit for foreign investment into or out of the United States.
- The proposal also does not suggest that the Virgin Islands become a "tax haven" similar to the Cayman Islands where transactions are shrouded in

secrecy. Under arrangements similar to those in effect today, full access to any information available under law or treaty will be maintained. Indeed, under the proposal, the U.S. Treasury Department will be able to obtain information about transactions to which it otherwise would not have had access, if such transactions occurred outside of the United States.

* Finally, the proposal does not suggest that the U.S. Internal Revenue Service administer the tax laws in the Virgin Islands. Local administration is desirable for several reasons including the need of the Virgin Islands to maintain and increase the degree of local autonomy and the proven ability of the Virgin Islands Bureau of Internal Revenue to collect taxes efficiently and effectively.

The Virgin Islands proposal, a copy of which in legislative form, together with a section-by-section analysis, is attached at the end of my statement, would effectively accomplish all the objectives of tax reform that have been raised over the years. Through simplification, uncertainty with regard to administration would be reduced, and this in itself would help to stimulate investment. The centerpiece of the proposal, tax incentives for U.S. and foreign investment, would continue and expand the Territory's ability to offer the special advantages that are required to attract investment and contribute to economic growth and diversification in the Virgin Islands. Finally, in terms of fairness, the V.I. proposal would eliminate inequities of the existing system, by extending the principles of "qualified domestic reciprocity" to both individuals and corporations, with a neutral effect on U.S. revenues.

APPENDIX 1

TABLE
U. S. VIRGIN ISLANDS
INDUSTRIAL DEVELOPMENT PROGRAM CERTIFICATE HOLDERS (IDC)
(934b Corporations)

	1976	1978	1980
NO. OF CORPORATIONS	92	54	37
EMPLOYMENT AND COMPENSATION			
Total Employment (a)	4844	6796	5402
IDC empl. as a % of private sector empl. (b)	24.1%	32.5%	22.6%
Total Compensation (million) (b)	$40.1	$81.3	$65.9
Average Compensation (a)	$8420	$11,962	$12,201
V.I. Average Annual Gross Pay (b)	N.A.	$9018	$11,285
TAX SUBSIDY			
Income Tax Subsidy (million) (a)	$23.2	$18.6	$32.8
Income Tax Subsidy/employee (a)	$4,785	$2,737	$6,078
Income Tax Subsidy as a % of Compensation	56.8%	22.9%	49.8%
DIRECT AND DERIVATIVE INCOME TAX REVENUE AND EXPENDITURE			
Corporate Income Taxes paid (million) (*b)	$7.8	$11.3	$14.0
Individual income tax (million)(*b)	$6.4	$12.6	$10.6
Direct Operating Expenditure and Consumption Spending			
Direct Overhead/Operating Expenditure (million) (c)	$30.2	$60.1	$50.8
Employee Consumption Spending (d)			
(first round) (million)	$22.9	$45.0	$38.5
Total (million)	$67.3	$129.5	$113.9

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* estimate

(a) Department of the Treasury, the Operation and Effect of the Possessions Corporation System of Taxation, First, Third and Fourth Reports.

(b) U. S. Virgin Islands Department of Labor, Bureau of Labor Statistics.

(c) Estimated as .95 of payroll expenditure.

(d) Estimated as .9 of after-tax payroll.

Source: U.S. Virgin Islands, Office of the Governor, Governor's Federal Tax Council, May 1985.

APPENDIX 2

A Bill to Amend Titles 26 and 48 of the United States Code with Respect to the Income Tax Law Applicable to the United States Virgin Islands.

* * * * * * * * *

Be it Enacted by the Senate and House of Representatives of the United States of America in Congress Assembled:

SECTION 1. COORDINATION OF UNITED STATES AND VIRGIN ISLANDS INDIVIDUAL INCOME TAXES

(a) In General - Subpart D of Part III of Subchapter N of Chapter 1 of the Internal Revenue Code of 1954 (relating to possessions of the United States) is amended by adding at the end thereof the following new section:

"SECTION 937. COORDINATION OF UNITED STATES AND VIRGIN ISLANDS INDIVIDUAL INCOME TAXES

"(a) Application of Section.--This section shall apply to any individual for the taxable year who--

(1) is a resident of the Virgin Islands or files a joint return for the taxable year with an individual who is a resident of the Virgin Islands, or

(2) has income from sources within the Virgin Islands for the taxable year or income from

sources outside the Virgin Islands which is effectively connected with the conduct of a trade or business in the Virgin Islands for the taxable year, and is a citizen or resident of the United States (but is not a resident of the Virgin Islands) or files a joint return for the taxable year with an individual described in this paragraph (2).

"(b) Filing Requirements.--

(1) In general.--Each individual to whom this section applies for the taxable year shall file his income tax return for the taxable year--

(A) with the Virgin Islands, if such individual is described in subsection (a)(1) of this section, and

(B) with the United States and the Virgin Islands if such individual is described in subsection (a)(2) of this section.

(2) Determination date.--For purposes of this section, the determination of residence for the taxable year shall be made as of the close of the taxable year.

(3) Special rule for joint returns.--In the case of a joint return, this section shall be applied on the basis of the residence and

citizenship of the spouse who has the greater adjusted gross income (determined without regard to community property laws) for the taxable year.

"(c) Extent of Income Tax Liability.--For purposes of determining the tax liability to the United States and the Virgin Islands of any individual to whom this section applies for the taxable year--

(1) for purposes of so much of this title (other than this section, section 934 and Part I of this subchapter) as relates to the taxes imposed by this chapter, the United States shall be treated as including the Virgin Islands; and

(2) for purposes of those provisions of the Virgin Islands territorial income tax corresponding to the provisions described in paragraph (1), the Virgin Islands shall be treated as including the United States.

(3) Any such individual, if required to file his income tax return for the taxable year with the Virgin Islands pursuant to subsection (b)(1)(A) of this section--

(A) is hereby relieved of liability for income tax to the United States for the taxable year upon satisfaction of his tax obligation to the Virgin Islands for the taxable year, and

(B) shall be allowed, as a credit against his Virgin Islands income tax liability for the taxable year, any payments made to the United States in respect of his income tax liability for the taxable year if such payments were required to be made to the United States.

(4) If such individual is required to file his income tax return with both the United States and the Virgin Islands pursuant to subsection (b)(1)(B) of this section, the following rules shall apply--

(A) The income tax liability of such individual to the Virgin Islands for the taxable year shall be equal to the income tax liability of such individual to the United States for the taxable year (determined without regard to this paragraph) multiplied by a fraction equal to such individual's Virgin Islands taxable income for the taxable year (as defined in subparagraph (B) of this paragraph) divided by such individual's taxable income for the taxable year.

(B) For purposes of subparagraph (A) of this paragraph, "Virgin Islands taxable income for the taxable year" shall mean taxable income from sources within the Virgin Islands for the taxable year and taxable income for the taxable year from sources outside the Virgin Islands which is effectively connected with the conduct of a trade or business in the Virgin Islands.

(C) For purposes of subparagraph (B) of this paragraph, in determining Virgin Islands taxable income for the taxable year:

(i) The principles contained in Part I of this subchapter (without regard to this section) shall apply and, in computing Virgin Islands taxable income for the taxable year, no deductions for personal exemptions under section 151 shall be allowed, and

(ii) Such individual's income tax liability to the Virgin Islands for the taxable year shall be allowed in full as a credit against his income tax liability to the United States for the taxable year.

"(d) Special Rules for Estimated Income Tax.-- If there is reason to believe that this section will apply to an individual for the taxable year, then--

(1) Such individual shall file any declaration of estimated income tax (and all amendments thereto) for the taxable year with the jurisdiction or jurisdictions with which he would be required to file his return or returns for such year under subsection (b) if his taxable year closed on the date he is required to file such declaration.

(2) Any individual described in paragraph (1) of this subsection is hereby relieved of any liability to file a declaration of estimated income tax (or amendments thereto) for the taxable year to the United States if such individual is required to file a declaration only with the Virgin Islands.

(3) Such individual shall make any payment of estimated income tax to the jurisdiction or jurisdictions with which he would be required to file his return or returns for such year under subsection (b) if his taxable year closed on the date he is required to make such payment.

(4) Such individual's liability for underpayments of estimated income tax for the taxable year shall be due to the jurisdiction or jurisdictions with which he is required to file his return or returns for such year under subsection (b).

"(e) Aggregation of Estimated Tax Payment.- For purposes of computing any addition to tax for underpayment of individual estimated income tax under Section 6654, an individual filing returns and estimated tax in both the Virgin Islands and United States may elect to aggregate estimated tax payments and tax shown on returns to the Virgin Islands and United States.

"(f) Regulations.--The Secretary or his delegate shall prescribe by regulation the information which individuals to which this section may apply shall furnish to the Secretary or his delegate."

SECTION 2. TREATMENT OF UNITED STATES INCOME TAXES UNDER THE REVISED ORGANIC ACT OF THE VIRGIN ISLANDS OF 1954

Section 1642 of Title 48 is amended by deleting, after the phrase "all persons whose permanent residence is in the Virgin Islands," the phrase "and such persons shall satisfy their income tax obligations under applicable taxing statutes of the United

States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands".

SECTION 3. CLARIFICATION OF NAVAL SERVICE APPROPRIATION ACT OF 1921

Section 1397 of Title 48 of the United States Code is amended by adding, at the end thereof, the following language: "Provided further, That the phrase 'income-tax laws' shall, for purposes of this section, mean

(A) the provisions of Title 26 of the United States Code (except those provisions expressly excluded from the operation of this section) relating to the imposition, assessment and collection of income taxes and to the enforcement of the income tax laws, and

(B) all final regulations promulgated by the Department of the Treasury pursuant thereto and published in the Federal Register after notice and comment, in accordance with the procedures established by section 553 of Title 5 of the United States Code."

SECTION 4. WITHHOLDING ON CERTAIN TYPES OF PASSIVE INCOME

Title 48 of the United States Code is amended by adding thereto the following new section:

"SECTION 1398. WITHHOLDING ON CERTAIN TYPES OF PASSIVE INCOME PAID TO UNITED STATES INDIVIDUALS.

"(a) Notwithstanding any other provision of law, the Legislature of the Virgin Islands is authorized to require all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the Virgin Islands), of any individual who is a citizen or resident of the United States, to deduct and withhold from such items an amount not to exceed 10% thereof and to remit such amount to the treasury of the Virgin Islands, such amount to be treated as a payment with respect to the income tax liability to the Virgin Islands of such individual.

"(b) Income items.--The items of income referred to in subsection (a) are those items of income referred to in the first sentence of section 1441(b) of Title 26, other than wages subject to withholding under Subchapter A of Chapter 24 of the Virgin Islands territorial income tax."

"(d) EXCEPTION FOR CERTAIN VIRGIN ISLANDS CORPORATIONS.- - In the case of a Virgin Islands corporation, subsection (a) shall not apply (if the information required by subsection (f) is supplied) if the conditions of both paragraph (1) and paragraph (2) are satisfied:

(1) Three Year Period.- -If 80 percent or more of the gross income of such corporation for the 3 year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources outside of the United States (as defined in Section 7701(a)(9)); and

(2) Controlled Foreign Corporation.- -If such corporation is not a controlled foreign corporation (as defined in Section 957).

For purposes of the preceding subsection the gross income of a Virgin Islands corporation, and the sources from which the income of such corporation is derived, shall be determined as if the corporation were a domestic corporation.

"(e) EXCEPTION FOR CERTAIN VIRGIN ISLANDS TRUSTS AND PARTNERSHIPS.- -In the case of a Virgin Islands trust or partnership, subsection (a) shall not apply (if the information required by subsection (f) is supplied) to such trust or to the partners in such partnership if, in the case of a trust, the conditions of both paragraphs (1) and (2) are satisfied, and, in the case of a partnership, the conditions of both paragraphs (1) and (3) are satisfied:

(1) Three Year Period.- -If 80 percent or more of the gross income of such trust or partnership for the three year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources outside of the United States (as defined in Section 7701(a)(9)); and

(2) Beneficiaries of a Trust.- -Under regulations prescribed by the Secretary, the combined beneficial interest of all United States persons (as defined in Section 7701(a)(30)) in such trust shall constitute no more than fifty percent of the total beneficial interest in such trust; or

(3) Partners of a Partnership.- Under regulations prescribed by the Secretary, the combined partnership interest of all United States persons (as defined in Section 7701(a)(30) in such partnership shall constitute no more than

fifty percent of the total partnership interest in such partnership.

(b) Section 934 of the Internal Revenue Code is further amended by adding after subsection (h) the following new subsection:

"(i) EXCEPTION FOR TAXATION OF PASSIVE AND BRANCH INCOME.- - For purposes of determining the tax liability incurred to the Virgin Islands pursuant to Part II of Subchapter N of this title (as made applicable to the Virgin Islands) with respect to amounts received from sources outside of the United States (as defined in Section 7701(a)(9))-

(1) The taxes imposed by Sections 871(a)(1) and 881 (to the extent applicable to the Virgin Islands) shall apply except that "10 percent" shall be substituted for "30 percent" and

(2) subsection (a) shall not apply to such taxes."

(c) Section 934A of the Internal Revenue Code of 1954 is hereby repealed.

(d) Section 1444 of the Internal Revenue Code of 1954 is amended by deleting the present language and substituting the following:

"For purposes of determining the withholding tax liability incurred to the Virgin Islands on amounts subject to tax under Part II of Subchapter N of this title (to the extent applicable to the Virgin Islands) with respect to amounts received from sources outside of the United States (as defined in §7701(a)(9)), the rate of withholding tax under sections 1441 and 1442 on income subject to tax under Part II of Subchapter N of this title (as modified by Section 934) shall not exceed the rate of tax on such income under Part II of Subchapter N of this title."

SECTION 7. TECHNICAL AND CONFORMING AMENDMENTS

(a) The second sentence of Section 932(a) of the Internal Revenue Code of 1954 (relating to citizens of possessions of the United States) is amended by inserting the phrase "or the United States Virgin Islands" after the word "Guam".

(b) Subsection (b) of Section 932 of such Code is amended by striking out all after "(b) Virgin Islands.--" and adding in lieu thereof the following: "For provisions relating to the individual income tax in the case of the Virgin Islands, see section 937; see also the Naval Service Appropriation Act of 1922 (Act of Congress, July 12, 1921, c. 44. Section 1, 42 Stat. 123)."

(c) Section 7701(a)(12)(B) of such Code (relating to performance of certain functions in Guam or American Samoa) is amended by striking out "(B) Performance of certain functions in Guam and American Samoa.--The term 'delegate', in relation to the performance of functions in Guam or American Samoa" and inserting in lieu thereof "(B) Performance of certain functions in Guam, American Samoa or the United States Virgin Islands.-- The term 'delegate', in relation to the performance of functions in Guam, American Samoa or the United States Virgin Islands".

(d) The table of sections for subpart D of Part III of subchapter N of Chapter 1 of such Code is amended by adding at the end thereof the following: "Section 937. Coordination of United States and Virgin Islands Individual Income Taxes."

SECTION 8. EFFECTIVE DATES

[Reserved]

APPENDIX 3

VIRGIN ISLANDS TAX ACT OF 1985

Section-by-Section Analysis

Section 1. Coordination of United States and Virgin Islands Individual Income Taxes.

Section 1 adds to the Internal Revenue Code of 1954 a new Section 937 which coordinates, for individuals, filing requirements and income tax liabilities to the United States and the Virgin Islands.

Applicability. Section 937 applies to (1) Virgin Islands residents, (2) spouses filing joint returns with Virgin Islands residents, (3) U.S. citizens or residents (other than Virgin Islands residents) deriving income from the Virgin Islands, and (4) spouses filing joint returns with persons in category (3).

Filing requirements. Under Section 937(b), Virgin Islands residents (and spouses filing joint returns with such residents) file a single return with the Virgin Islands only. United States citizens and residents deriving income from the Virgin Islands (and spouses filing joint returns with such persons) file a return with both the United States and the Virgin Islands. In the case of a joint return, filing status is determined on the basis of residence of the spouse with the greater adjusted gross income for the taxable year. Determinations of residence for a taxable year are made as of the last day of the taxable year. In the case of a United States individual filing a return with both the United States and the Virgin Islands, a single form may be used, since the tax liability to the Virgin Islands is not computed independently of the tax liability to the United States.

Extent of income tax liability. Section 937(c) provides that, for purposes of determining the income tax liability of persons to whom Section 937 applies, the Virgin Islands is treated as domestic to the United States, and the United States is treated as domestic to the Virgin Islands. Under this rule, an individual to whom Section 937 applies computes taxable income only once for both jurisdictions.

If the individual (or his spouse with whom he files a joint return in the Virgin Islands only) is a Virgin Islands resident, his entire tax liability is to the Virgin Islands, regardless of the source of income, and there is no tax liability to the United States.

In the case of a United States individual with income derived from the Virgin Islands (or a United States spouse with whom he files a joint return), the portion of his income tax liability allocated to (and paid directly to) the Virgin Islands is determined by multiplying the total tax liability by a fraction of which the numerator is taxable income derived from the Virgin Islands and the denominator is total taxable income.

Estimated income tax. Section 937(d) provides that, in the case of any individual who may be subject to Section 937 for the taxable year, any declaration of estimated income tax, and all estimated income tax payments, must be directed to the jurisdiction with which he would be required to file his return if the taxable year closed on the date he is required to make the declaration, or make the payment, as the case may be. Any individual filing a declaration of estimated income tax or making an estimated income tax payment pursuant to Section 937(d) is relieved of liability for such declaration or payment to the jurisdiction other than the jurisdiction specified by Section 937(d).

Section 2. Treatment of United States Income Taxes Under the Revised Organic Act of the Virgin Islands of 1954.

Section 2 amends Section 28(a) of the Revised Organic Act of the Virgin Islands by deleting the language which, in effect, exempts Virgin Islands "inhabitants" from United States income taxes. The function of the repealed language is performed in substantial part by (A) new Section 937 (in the case of individual income taxes), (B)Section 881(b) (in the case of the 30% withholding tax on United States source passive income of certain Virgin Islands corporations) added by the Tax Reform Act of 1984, and (C) the extension of the Section 243 dividends received deduction to U.S. shareholders of Virgin Islands corporations (*see* Section 7).

Section 3. Clarification of Naval Service Appropriation Act of 1921.

Section 3 clarifies those provisions of the Naval Service Appropriation Act of 1922, which cause the income tax laws of the United States to be in force in the Virgin Islands. Under the clarification, the phrase "income tax laws" refers only to the provisions of the Internal Revenue Code of 1954 (except for those provisions expressly excluded), and final regulations promulgated by the U.S. Department of the Treasury.

Section 4. Withholding on Certain Types of Passive Income.

Section 4 adds a new section to the Naval Service Appropriation Act, authorizing the Virgin Islands Legislature to require withholding (at a rate not to exceed 10%) on most classes of passive income paid from Virgin Islands sources to United States individuals. The classes of income with respect to which withholding may be required include all classes of income currently subject to withholding under Section 1441 and 1444 of the Virgin Islands territorial income tax, other than amounts which, under new Section 937, will be subject to withholding under Chapter 24 of the Virgin Islands territorial income tax (i.e., wages). This amendment of the Naval Service Appropriation Act is made necessary by the technical or implied repeal of the current provisions authorizing withholding on passive income of U.S. individuals by the Virgin Islands (Sections 934A, 871, 1441, and 1444 of the Internal Revenue Code).

Section 5. Provisions Regarding S Corporations.

Section 5 amends the provisions of the Internal Revenue Code regarding S corporations (formerly "Subchapter S corporations"). Under the amendments, Virgin Islands individuals will be able to become shareholders of United States S corporations and United States individuals will be able to become shareholders of Virgin Islands S corporations.

Section 6. Provisions Affecting the Tax Liability of Foreign Persons.

Section 6(a) amends Section 934 of the Internal Revenue Code by adding a new subsection (designated Section 934(d)) which exempts certain Virgin Islands corporations from the limitation on reduction in income tax liability to the Virgin Islands under Section 934(a) provided that such corporations meet certain gross income tests and are not controlled foreign corporations. Section 6(a) also amends Section 934 of the Internal Revenue Code by adding a new subsection (designated Section 934 (e)) which exempts certain Virgin Islands trusts and partnerships from the Section 934(a) limitation on reduction in income tax liability to the Virgin Islands. Section 6(b) and (c) add new subsection 934(i) which reenacts and expands Section 934A of the Internal Revenue Code by extending the limitation on the Virgin Islands tax on certain passive investment-type income to include foreign persons as well as U.S. persons. In addition, the Government of the Virgin Islands is permitted to reduce the rate of such tax at its discretion. Section 6(d) amends Section 1444 to limit the withholding rate to an amount equal to the rate set forth in new Section 934(i).

Section 7. Conforming Amendments.

Section 7 includes several technical amendments which are necessary to conform various sections of the Internal Revenue Code to the provisions of new Section 937 and an amendment to the Revised Organic Act of the Virgin Islands (*see* Section 2).

Section 8. Effective Dates.

[Reserved]

The CHAIRMAN. Governor Hernandez Colon, you know the argument that is made about 936 in Puerto Rico, that it:

> Becomes a tax shelter for pharmaceuticals and electronics companies that are capital-intensive, low employment, and they can shelter their patent profits by doing their work in Puerto Rico.

Now, that is the argument that is made.

I am curious about the study that you had commissioned investigating the wage credit, and the conclusion that it reached, and I am quoting as follows:

> The Puerto Rican wage rates have increased relatively faster than skill levels; thus, making Puerto Rico less attractive to investors. The result is that recent Puerto Rican investment is concentrated more heavily in the highly capital-output and high capital-labor ratio industries such as chemicals and pharmaceuticals, and thus provides less economic growth and employment.

Can you comment on that study?

Governor COLON. Senator, the problem of our labor force and the skills of our labor force, and the way that this reflects itself in the type of employment that exists in Puerto Rico, is a reality. And it is a reality that we must address through educational and training programs.

However, the 936 opportunities have allowed us to face up to that problem with the type of opportunities that are created for the workers that exist now, as they are trained now, in Puerto Rico.

So, in that sense, in that context, 936 has also been a benefit to Puerto Rico.

The CHAIRMAN. Are you saying that the kinds of jobs that 936 creates are higher paying, middle class or upper middle class, and that what they are going to give is a stability and a leadership that you might not get from wage credit jobs, which in all likelihood would be lower paying jobs although there might be more of them?

Governor COLON. We are saying that.

Now, at the same time we can say that the most reasonable approach that could be taken to the Puerto Rican unemployment problem, from the point of view of tax policy, would be to make the wage credit an alternative to 936, so that they both could coexist, and therefore the industries that would benefit by such a wage credit could have the opportunity for coming into Puerto Rico while the 936 companies stayed. And therefore, we may be able then to make a larger inroad into the unemployment problem.

See, if it is a substitute for 936, then it is a disaster. But if it is an additional option——

The CHAIRMAN. Oh, I can understand the additional option, and I can understand why you would like to have both very much. I don't want to mislead you: I don't think you are going to get both. But, between the two, you would rather stick with 936 than the wage-credit proposal?

Governor COLON. Absolutely. Absolutely.

The CHAIRMAN. Governor Luis, you are the only witness we have had in all the hearings we have had that, given the option to rewrite the code as you wanted, doesn't want to. I don't know of any other witness that wouldn't say, "Please, I would be happy to rewrite the Code to suit our benefit." I don't yet understand. My hunch is, if you don't want to, we won't make you. But given the option, given the option so that you could just pass a law that says, "We adopt the U.S. Tax Code," or change it, it would seem to be an advantage. And I don't understand why it isn't.

Governor **Luis**. Well, for the reasons I mention in my condensed statement and reasons you will find in the more detailed statement which I have submitted for the record. We would have serious administrative problems, and we will definitely create tremendous uncertainty for investors in the territory.

The **Chairman**. Where do the administrative problems come if the legislature just says, "We adopt the U.S. Tax Code"? Then you've got the same Tax Code we've got, but if for some reason you ever wanted to change it, you could.

Governor **Luis**. Well, we have this situation where because of the favorable image of our Bureau of Internal Revenue which stems from its association with the IRS, we have taxpayers who are more likely to comply with paying their taxes.

The **Chairman**. Now, say that again. The favorable image of association with the IRS? [Laughter.]

Governor **Luis**. Yes, sir. Once the association with the IRS is removed, then we would have more abuses; so, we prefer to maintain that tax policy relationship that we have had with the United States. In our case, unlike other areas, it is a system that has been efficient, and we want to maintain what is efficient and not experiment with something that we will have to rework all over again.

The **Chairman**. Thank you.

Governor **Luis**. It sounds very easy, you know, "delink and adopt your system." Then you are faced with another set of problems, because other people then will be deciding what tax to impose, and what have you, and you are going to create some real serious problems on another level, which I do not want to bring up here, Senator. [Laughter.]

The **Chairman**. Senator Long.

Senator **Long**. Governor Hernandez Colon, first let me thank you. You were an extremely gracious and thoughful host when I last visited Puerto Rico. All of us who went there were very much impressed by the fine work you are doing, and also by your generosity and kindness to all of us. We want to thank you for the consideration you gave us when we visited you.

Governor **Colon**. It was my pleasure, Senator.

Senator **Long**. I mentioned something to you on that occasion that I have been thinking a lot about since that time. I want to discuss it briefly here while I have this opportunity.

You say that you have 22-percent unemployment. I see that we are paying out $826 million in food stamps to Puerto Rico, mostly for food assistance. Now, if I were in your situation, I would welcome the opportunity to reprogram some of that $826 million to put some people to work, rather than paying them just to sit there and draw food stamps. I don't know that I would employ them on a 40-hour week; I think maybe I would put people to work about 20 hours a week, and that way I could employ twice as many.

There are a lot of things you could do in the public sector: Providing services, cleaning up beaches, and things like that. I would think there is even more potential if you were permitted the flexibility to subsidize people into private employment. For example, Puerto Rico produces very little in the way of sugar, tropical fruits, and things of that sort. It has been explained why not; but, if you had the flexibility to use some of that money to subsidize employment in private areas, I think that many more employment opportunities are available there than in the public sector.

I would like to work with you on that, if you would send somebody up here to help us work out a program. I would be willing to vote to give you complete flexibility to use that money however you wanted to use it to put people to work.

I am sure that the bureaucrats in Washington would like to see some regulation as to how you propose to do it. Do you think that you might be able to work with us on that?

Governor COLON. Yes, I would be very glad to send somebody up here to work with you on that, Senator.

Senator LONG. Frankly, I believe that one of the greatest things we could do for this country is to take money we are paying people—on food stamps and otherwise—just to sit around and be idle and subsidize those people into jobs. You know, it is said "An idle mind is the devil's workshop." They could be doing something to benefit the community.

I am not talking about $10-jobs. I mean subsidize them into minimum-wage jobs at least, so that they would be benefiting their fellow human beings and benefiting society—Puerto Rico, in particular—to help reduce the unemployment and put people into constructive work.

If you will send somebody up here, I promise you I will do my best to help get results.

Governor COLON. We certainly will, and we appreciate the spirit in which your suggestion is made. We certainly do, and you will have somebody up here.

Senator LONG. You understand that to the extent that you are paying people to work, that leaves you less money to distribute grants or giveaways. But I believe that your people would approve on something where you tell them that "every nickel you save on food stamps is being paid to people to work and benefit the community."

Governor COLON. The Puerto Rican people want to work. And what we have to make available to them are jobs and options. And I am sure that if we sit down and look at this creatively, we can come up with something that will give them those alternatives that they are looking for.

Senator LONG. We have done a lot in the effort to put people to work in the public sector; but everybody who has ever worked in that area tells me that there are a lot more jobs to be created in the private sector than in the public sector, if we would let them use money for that purpose.

Governor COLON. That is true.

Senator LONG. You might be able to prove something that benefits the entire United States by doing something along that line.

Governor COLON. I would be very glad to take a look at that, sir.

Senator LONG. Well, thank you very much.

The CHAIRMAN. Senator Matsunaga, are you next? Excuse me, Senator Mitchell.

Senator MITCHELL. Go ahead, Sparky.

Senator MATSUNAGA. Thank you very much, Mr. Chairman. I am sorry for the delay; I had to testify before another committee before coming here, and I am sorry I missed the others, my good friends who share the status of government which Hawaii suffered for many, many years.

Have you ever both thought of the one solution which Hawaii sought to all of its problems? [Laughter.]

Governor COLON. It will bring to us more problems. [Laughter.]

Senator MATSUNAGA. Well, Hawaii resolved many of its problems by becoming a State. Have you ever thought of becoming a State?

Governor COLON. Well, different circumstances.

Senator LONG. Governor, if you do, I suggest you run for the Senate. We could use you around here. [Laughter.]

Senator MATSUNAGA. Well, Governor Hernandez Colon, as you know, the Congress reexamined section 936 in 1982 in order to eliminate so-called abuses. Has the Treasury provided specific examples of abuse that would warrant altering section 936 once again?

Governor COLON. No, Senator, they have not. And we have met with them on a number of occasions. They have not been able to date to sustain the charge of abuses that has been made and that has been going around the town. We have told them that we are willing to sit down with them to see what the abuses are. When our people have sat down with them—staff people, concretely—they have not been able to produce such abuses; that is, if "abuses" are understood as abusing the existing legislation. What they are saying to us is that the legislation does not work, that it should be another way. Well, to us, that is not an "abuse." An "abuse" is to misuse the existing legislation, and that they have not been able to demonstrate to us.

Senator MATSUNAGA. Do you find that one of the real problems in dealing with Uncle Sam is that we change the tax laws too often.?

Governor COLON. It is a very serious problem. I think Puerto Rico could have a better economic situation if we had this uncertainty removed from us, and we could work under stable rules where we could promote business and business would be willing to make decisions. But decisions are not made in this type of climate. It is very hurtful.

Senator MATSUNAGA. Governor Luis, do you have anything to add in this connection?

Governor LUIS. No, Senator.

Senator MATSUNAGA. I recall a few years ago, the Virgin Islanders used to come here with big buttons pinned on their breast, reading: "I am a Virgin Islander." I don't see those signs anymore; what happened? [Laughter.]

Governor LUIS. I think that was a promotion effort during a time in which it was most effective to do so. [Laughter].

Senator MATSUNAGA. One of the major criticisms of section 936 is that it encourages investment by a small number of drug companies, and has not been an effective incentive to assist employment across the board. What effect would the proposed wage credit have on employment?

Governor COLON. Well, 936 has been effective even for the lower wage industries such as the garment industry. However, in that area the wage credit could be even more effective for certain companies. We think that if the wage credit was added on to 936, we would have a better opportunity to deal with the large unemployment that we have in Puerto Rico. We would keep the 936 jobs, and we would be able to go after this other type of job.

Senator MATSUNAGA. Thank you very much; I see my time is up.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

Governor Hernandez Colon, it is a pleasure to see you again, and I join the other Senators in welcoming you here before our committee.

Governor COLON. It is a pleasure to see you, Senator. Thank you.

Senator MITCHELL. And I commend both you and Governor Luis for your very fine statements.

I would like to ask you, Governor Hernandez Colon, one of the options being considered by the Ways and Means Committee would eliminate the cost-sharing provision. I would like to ask for your opinion on what the effect of that elimination would be on those companies that now utilize section 936 in Puerto Rico.

Governor COLON. This is a highly technical matter. It involves matters of accounting. But I am informed that the electronics industry which exists in Puerto Rico, and which is very meaningful to us, could not accommodate itself, could not work, with the profits-split method, which would be the method which they would have to use if the cost-sharing method was eliminated. It presents a very serious problem to them.

Also, I must comment that this was a Treasury proposal in 1982, and that no abuses have been demonstrated that would lead us to accept the change that is being proposed now.

Senator MITCHELL. If changes were made in section 936 or in any of the divisions involved that resulted in companies who currently operate because of its provisions in Puerto Rico, or who may do so in the future, and it affects them in such a way that they can no longer continue their operations there because they do not find it advantageous to do so, one of the questions is: What will they do? In your judgment, would those companies resume or take those operations and bring them back to this country, so that it would result in more employment in the United States? Or would they go to some other offshore location?

Governor COLON. In my judgment, from everything that I have heard since we have been dealing with this problem and talking to the companies, in my judgment over 90 percent of them would go to foreign countries and not back to the United States.

Senator MITCHELL. I think, Governor, that is perhaps the most critical question of all, because all of us are concerned about the serious problems of unemployment and economic development in Puerto Rico. We are similarly concerned about the same type of problems in various parts of the United States, although of course not as serious. And I think we would be reluctant to take any action which would have an adverse effect on Puerto Rico with no compensating benefit here in the United States.

I would ask you if subsequent to this hearing you would prepare a written statement documenting, to the extent possible, the conclusion you have just stated. That really is the critical question, I think, in terms of what we do with respect to this provision and various parts of it in the future.

Governor **Colon**. I would be very glad to do that. It will not be difficult to document it.

Senator **Mitchell**. Now, were we to make major changes in Section 936, cost-sharing or any other provision that would render it not attractive to those American companies now utilizing it in Puerto Rico, what would be the effect, in your judgment, on the economy of Puerto Rico—the problem of unemployment, and other social problems?

Governor **Colon**. We have a 22-percent unemployment now. You know, depending on whatever change is made, our unemployment is going to shoot up. If it were eliminated completely as the Treasury proposes, this would easily double. I mean, this would have a devastating impact on Puerto Rico. It is hard to communicate the seriousness of the matter as it refers to the original Treasury proposal.

Now, the other changes are less severe in their effects; but, nonetheless, they will hurt us. And I believe if we are looking at an area such as Puerto Rico that has such a serious unemployment problem, the most serious throughout the country, then we should be looking for ways to solve that problem, not to increase the problem.

Senator **Mitchell**. Well, my time is up. I thank you very much Governor, for your comments.

The **Chairman**. Senator Long, and the others?

Senator **Long**. No questions, Mr. Chairman.

The **Chairman**. Senator Matsunaga.

Senator **Matsunaga**. No questions, Mr. Chairman.

The **Chairman**. Governors, we appreciate it very much. Thank you for taking the time.

Governor **Colon**. Thank you.

Governor **Luis**. Thank you so much.

The **Chairman**. Thank you.

Gentlemen, as I have indicated to the previous witnesses, your entire statements will be in the record. We would appreciate it if you would abbreviate your comments, and hold your oral statements to 5 minutes.

We'll start with Senator Hernandez-Agosto, the president of the Puerto Rican Senate.

Senator.

STATEMENT OF HON. MIGUEL HERNANDEZ-AGOSTO, PRESIDENT OF THE SENATE OF PUERTO RICO

Senator **Hernandez-Agosto**. Mr. Chairman, members of the committee, I wish to thank you for the opportunity to appear before this committee to express my views and concerns in relation to section 936 of the Internal Revenue Code.

I will address myself to the policy issues rather than the technicalities of the section. Section 936 is more than just a tax provision.

It is a policy. It is a concept. The concept behind it is the economic development of Puerto Rico through private enterprise with Government assistance and the availability of a tool for Puerto Rico to help itself, which in the long run should reduce dependence on U.S. grants and Government assistance.

What have been the results out of this policy? First, we have created some 80,000 direct jobs; another 100,000 indirect jobs. There is a growing middle class resulting from high-technology better paid jobs. We have created a mortgage trust with 936 funds that will initially finance 5,000 housing units, at the same time that jobs are created. We are funding a new development bank with 936 funds to promote economic growth by providing risk capital to promising new ventures.

Even with 936 operations in Puerto Rico, we stand to have chronically high unemployment rates. Faced with this situation, the government of Puerto Rico has adopted a number of decisions. We have adopted very strict regulations on the use of 936 funds deposited in banks in Puerto Rico 20 percent of those deposits must be invested in Government securities; 10 percent must be redeposited in the Government Development Bank; 7 percent must be invested in home mortgages, and the balance must finance eligible activities which foster investment rather than consumption.

As a result, the cost of money for these activities is one to two points lower than current rates. This represents savings of approximately $120 million to the economy of Puerto Rico.

We have approved legislation to promote economic development such as the following: We have reduced the maximum income tax rate from 67 percent to 50 percent; we have eliminated the inheritance tax. Both actions take a lot of political courage, but shows that the responsibility with our future comes first, comes before political convenience. We have reduced taxes on savings. And we have approved special tax legislation to stimulate the construction industry.

On the other hand, the United States has much to benefit also from the operation of 936 corporations in Puerto Rico. As a result of 936 operations in Puerto Rico, we buy $2.2 billion from the United States in raw materials, and in consumer goods. These purchases generate in turn $5.7 billion in economic activity in the United States, creating 83,000 jobs here with a payroll of $1.3 billion. The United States, in addition, gets assistance from Puerto Rico which is very important to its policy positions. We can strengthen the development of the Caribbean Basin Initiative; we can add political and economic stability in the Caribbean area, and so strengthen the national security of the United States.

Aware of the above considerations, Treasury modified its original position and, in essence, has recommended that the changes proposed originally be implemented 5 years from now. Now, the House Ways and Means Committee staff is recommending the elimination of the cost-sharing provision of section 936 and to tax 17 percent of passive income. This new proposal, while it shows understanding that the wage credit is not an adequate substitute to the tax credit, will still have the effect of an intolerable, immediate and lasting damage. Actually, it appears to me that it is inconceivable to reverse a good policy decision for a meager amount of additional revenues. Actually, the discussion should not be on the elimination or reduction of the effectiveness of section 936, but rather how to strengthen it. And in this position, we have in Puerto Rico just one voice. Government, trade associations, labor unions, civic, cultural and religious organizations are altogether to defend 936 as an instrument for the development of Puerto Rico.

Thank you, Mr. Chairman. Thank you, gentlemen.

The CHAIRMAN. Thank you, Senator.

[The prepared written statement of Senator Hernandez-Agosto follows:]

STATEMENT BY MIGUEL A. HERNÁNDEZ AGOSTO

President of the Senate of the
Commonwealth of Puerto Rico

INTRODUCTION

The U.S. Treasury Department has recommended that the tax credit provisions of Section 936 of the Internal Revenue Code be repealed.[1] Their reasons are (a) the federal government is foregoing about $1.7 billion in corporate income tax; and (b) employment attributable to this loss of revenue is inadequate. Treasury suggests that less expensive employment incentives, such as a system of labor credits, be made available.

While Treasury provides no indication of what would be considered a sufficient level of employment to justify the taxes foregone, it is clear that the minimal analysis done by Treasury to support its assertions is inadequate. We find the conclusions reached to be wrong: Treasury has greatly understated the benefits Puerto Rico derives from Sec. 936, has totally ignored the related benefits to the U.S. economy, and has overstated tax revenues that would be realized if Sec. 936 were modified.

To quantify the actual impact of the operations of 936 Corporations, Puerto Rico has commissioned a series of rigorous and thorough cost/benefit studies. I would like to share with you the results of studies completed to-date.

These results show that our economy stands to be harmed severely by the proposed repeal of Sec. 936 tax credits; yet, we will reap no offsetting benefits from other aspects of the tax reform bill under consideration. The magnitude of our injury will far outweigh the minimal added revenue that the federal government can expect to receive. And, ultimately, additional costs will be borne by state and local governments.

My purpose, then, is to question the rationale and wisdom of eliminating Sec. 936 tax credits when the costs of doing so are certain to outweigh the benefits.

EMPLOYMENT

Treasury asserts that the employment created by 936 Corporations -- 81,250 in 1982 -- is insufficient to justify the taxes foregone by the federal government. We do not know what would be considered sufficient, but we have determined that Treasury has underestimated the number of jobs attributable to the operations of 936 companies. The studies done for the Senate of Puerto Rico include the use of an econometric model from which employment multipliers for both Puerto Rico and the United States can be derived. Using these multipliers, it is found that over 260,000 jobs were generated by 936 Corporations in 1981.[2] The total breaks down as follows:

EMPLOYMENT GENERATED BY 936 CORPORATIONS

In Puerto Rico:		
Direct employment	79,000	
Indirect Employment	100,330	
Total		179,330
In the United States:		
Input Suppliers and Derived Purchases		
Total		82,950
Total Jobs (1981)		262,280

936 Employment in Puerto Rico: Direct

Direct employment is defined as jobs created directly through investments by Sec. 936 Corporations. These are easily identified as employment in plants and businesses established by 936 Corporations in Puerto Rico. Over the past five years, direct manufacturing employment in 936 plants has averaged over 80,000 people. This means that 60 percent of the manufacturing jobs in Puerto Rico are at stake in your deliberations.

There are special benefits of employment in Sec. 936 Corporations, especially the upgrading of Puerto Rico's labor force through training for jobs in high technology industries. The U.S. Department of Treasury, in its Third Annual Report, found that the jobs provided by Sec. 936 firms are "better" jobs since there is:

> "a tendency of the high-profit industries to employ more highly skilled workers and/or to pay those workers more than they would have been paid by other Puerto Rican employers."[3]

An illustration is the following. The average employee in the chemicals and allied products industy earns 52.3 percent more than the average employee in manufacturing in Puerto Rico. Further, the chemicals sector alone now accounts for 27.0 percent of employee compensation by all Sec. 936 firms.

Altogether, the shift in employment to the high technology sector, thanks to 936 and complementary investment incentives, has helped create a sizeable middle class, which barely existed several decades ago. While this class is a smaller proportion of the population than in the States, it is growing and providing its children with opportunities for good health, education, and upward mobility. Our experience has been exceptional among developing economies and is worth perpetuating.

936 Employment in Puerto Rico: Indirect

Direct employment, however, is less than half the employment attributable to investments in Puerto Rico by Sec. 936 Corporations. There are over 100,000 additional jobs created by firms linked to 936 Corporations through the provision of supplies and services and through the purchase of goods and services with payroll earned by employees of 936 Corporations.

The number of jobs that are linked to direct employment in 936 Corporations is determined through the use of economic input/output models from which employment "multipliers" are derived. The Treasury Department staff has indicated substantial skepticism about the multipliers determined for Puerto Rico by the Puerto Rican Planning Board and economists at Citibank (2.35). Econometric models developed for the Senate of Puerto Rico produce a 2.27 employment multiplier for Sec. 936 manufacturing firms in Puerto Rico.[4] The relatively small difference between the two estimates may be explained, at least in part, by the fact that our multiplier is from an interregional input/output model while the others are from a regional model for Puerto Rico.[5] Nevertheless, the results are so close that our economists conclude that the value of the multiplier as calculated is estimated correctly for Puerto Rico.

936 Employment in Puerto Rico: Total

When we add direct and indirect employment created in Puerto Rico as a result of the operations of Sec. 936 Corporations, the total is nearly 180,000 jobs. This represents over 20 percent of the employed people in Puerto Rico. The importance of these jobs perhaps is best understood by the fact that if they had not existed in 1981, the unemployment rate in Puerto Rico would have been nearly double the actual rate of 19.9 percent.

Our economists tell us that even with Sec. 936, if there are no other changes in our economy, unemployment will continue to rise. Without Sec. 936, we are looking at over 30 percent of our labor force out of work by 1990.[6] Just imagine one-third of the workers in your states unemployed!

936 Employment in the United States

Operations of Sec. 936 Corporations in Puerto Rico generate substantial employment in the United States. This occurs in two ways -- from the demand for intermediate products and from the demand for final consumer goods.

Industries in Puerto Rico are generally less regionally integrated than their counterparts in the United States.[7] This means that when Sec. 936 manufacturing plants in Puerto Rico require materials, components, and supplies, they are more apt to order from firms outside of Puerto Rico, for example, from their parent corporations or traditional suppliers in the States. This very high level of interaction between production by Sec. 936 Corporations in Puerto Rico and sales to them by firms in the States constitutes the main source of 936 generated employment in the United States.

The second source of derived employment is for consumer goods sold to Puerto Rico. The 180,000 employees working in Puerto Rico because of investments by Sec. 936 Corporations earn wages and salaries with which they purchase goods and services. Some of these goods are imported from the United States. This level of imports creates output, income, and employment in the United States.

The impact of the combined demand for intermediate and final products is the employment of 83,000 persons in the United States. These are 83,000 jobs that exist only because of the operations of Sec. 936 Corporations in Puerto Rico.

If the tax credit provisions of Sec. 936 are repealed, our studies show that the States would lose approximatly 20,000 jobs.[8] The main reason is the relocation of Sec. 936 firms from Puerto Rico to foreign countries, such as Mexico or Korea. These countries tend to require a high degree of local content in manufacturing; i.e., a high proportion of materials, components, and supplies must be purchased locally. Similarly, in an effort to promote local industry, trade barriers are erected against the importation of consumer goods. The effect of these restrictions would be to limit the volume of intermediate and final goods imported from the United States. U.S. firms would not benefit from increased output, and employment would be cut. Thus, a substantial number of jobs, as well as related personal and corporate income, would be lost in the United States as firms moved from Puerto Rico to foreign countries.

FEDERAL TAXES AND EXPENDITURES

Treasury has estimated that about $1.7 billion in revenue is lost to the United States under the tax benefit provisions of IRS Sec. 936. Our studies show that this estimate is overstated by a factor of four. A large part of the overstatement derives from over-optimistic assumptions regarding the reactions of Sec. 936 firms to the appeal of the tax credit provisions of Sec. 936. A second source of error is in neglecting to account for the additional government expenditure that would be required to compensate for the loss of jobs and income now generated by Sec. 936 Corporations.

Some of these adjustments have been quantified in the studies completed to-date. The partial results show that if Sec. 936 tax credits were to be repealed, the federal government might expect revenues of about $376 million.[9]

REVENUE IMPACT ON THE FEDERAL BUDGET OF REPEALING SEC. 936 TAX CREDITS

Corporate Tax Receipts	$452 million
Personal Income Taxes	18 million
Import Duties	57 million
Wage Credits	(70 million)
Total Taxes and Duties	$457 million
Transfer Payments	(81 million)
Net Direct Impact	$376 million

The estimates above do not include the indirect effects on personal or corporate income taxes or the impact on the budget of the government of Puerto Rico.

Direct Taxes and Duties

Two types of recalculations of anticipated taxes were made: those directly involving tax rates and exclusions and those involving assumptions as to the relocation of Sec. 936 Corporations.

The first set of revisions included reduction of the maximum corporate income tax rate to 33 percent, as is proposed under current tax reform bills, and adjustments to account for changes in the tax treatment of intangible income. Altogether, these adjustments reduce Treasury's estimate of tax revenue by $122 million.[10]

The second, and more substantial of the two types of recalculations, takes account of erroneous assumptions regarding the probable reaction of firms to repeal of Sec. 936 tax credits. These adjustments total over $1.0 billion.[11]

The Treasury staff appears to have made the assumption that upon repeal of the tax credit provisions of Sec. 936, all Sec. 936 Corporations would commence paying federal corporate income tax on their earnings in Puerto Rico. Studies recently completed for Puerto Rico show that this assumption is invalid. Not all firms would remain under the primary taxation jurisdiction of the federal government. A breakdown of expected reaction and its impact is as follows.[12]

REACTION OF SEC. 936 FIRMS TO REPEAL OF TAX CREDITS

	Employment Accounted for by Sec. 936 Firms	Expected Impact on Federal Tax Revenue
Relocate to Mainland U.S.	6.0% - 15.0%	full corporate taxes
Relocate to Other Countries	12.0% - 34.0%	deferred taxation
Remain in Puerto Rico:	49.5% - 76.5%	
apparel industry		adjusted rate
other firms		deferred taxation

One task in the studies commissioned by Puerto Rico was to determine the likely reactions of firms to a repeal of Sec. 936 tax credits and introduction of a system of wage credits. The finding of a comprehensive analysis of relative profitability was that only one industry, apparel, would realize a higher rate of return by staying in Puerto Rico without the benefits of Sec. 936 and with the proposed tax credits.[13] If it is assumed that all Sec. 936 firms in the apparel industry in Puerto Rico remain there and accept the system of wage credits, the cost to the federal government for these credits is estimated at $70 million.

It is expected that some companies in industries other than apparel would continue to operate in Puerto Rico, but as Puerto Rican corporations rather than as U.S. corporations. They would be subject, first, to Puerto Rican taxes. At best, the federal government would benefit from deferred taxes when income was "repatriated".

Firms accounting for up to one-third of employment in 936 Corporations would be apt to relocate outside of the United States, in foreign countries. Our studies have found that these firms would earn higher rates of return on their investments if they incorporated in the foreign countries in which they relocate. If this occurs, U.S. taxes will be deferred until such time, if ever, that income is repatriated to the parent corporation in the United States.[14] An offsetting revenue factor involving relocation to foreign firms is that the United States would receive custom duties on products made in these relocated plants and exported to the United States.

This leaves firms accounting for only 6 to 15 percent of employment in Sec. 936 Corporations that are expected to relocate to the United States mainland. These firms would be subject to the full corporate tax. In addition, the federal government would receive personal income taxes of about $18 million from employees of firms relocating to the States.

Transfer Payments

Companies relocating outside of Puerto Rico will leave unemployed workers. Given the high unemployment rate that already exists on the Island, it is unlikely that these workers will find new jobs soon.

Puerto Ricans have always exemplified the capitalist ideal of unrestrained labor mobility. Experience tells us that as unemployment rises on the Island, Puerto Ricans again will migrate to the States. This movement will be encouraged by the lower level of social benefits available in Puerto Rico than available in many mainland cities. What one might envision as a Puerto Rican problem will become a problem for everyone as our unemployed appear in your cities seeking jobs and welfare benefits.

Such migration is simply a reflection of economic pressure. From my point of view as a legislative leader, I am saddened and hurt to think we may be unable to provide for our people. And, as a legislative leader concerned with fiscal responsibility, I project an increase in federal expenditures from the elimination of Sec. 936. Our studies show that federal expenditures, alone, are projected at $80 million. This amount is for transfer payments in the form of unemployment compensation, food stamp payments and PAN, the Puerto Rican equivalent of food stamps, to unemployed workers in Puerto Rico and to Puerto Rican workers who migrate to the States and are unable to find work. Deducted from this are tax payments that would be due on income earned by migrating Puerto Ricans that do find jobs in the States.

ECONOMIC DEVELOPMENT

The benefits of IRS Sec. 936 go beyond the creation of direct and indirect employment and income. The existence of what are known as 936 funds are responsible for additional economic development in Puerto Rico, such as infrastructure. Further, these funds can be the immediate vehicle for spurring development of our Caribbean neighbors since they can be the basis of financing low cost investment in industries in these countries.

Puerto Rican Development

The funds for economic development derive from the incentive 936 Corporations have for deferring taxation on income earned by their Puerto Rican subsidiaries. Sec. 936 fund accumulations in Puerto Rico were $10.6 billion in 1983[15] and they have made a substantial contribution to ensuring the liquidity of the Island's financial system. Since 1976, we have intensified our efforts to use these funds to promote economic development. The Puerto Rican government, through its Treasury Department, the Government Development Bank, and other agencies, has promulgated regulations to reduce the cost of 936 source capital and encourage indigenous investment in Puerto Rico. The results are encouraging and have been documented in recent analyses undertaken at our request.

First, the interest rates on Commonwealth and public enterprise bonds have come down about two percentage points.[16] Now, they are approximately equal to the rates on state and municipal bonds. As a result, our annual savings on government debt exceeds $32 million, which, you will agree, is substantial.[17]

Second, the Government Development Bank, in cooperation with the Commonwealth's housing agency, has created a mortgage trust.[18] Sec. 936 funds are being used to finance up to 5,000 housing units with 25-year mortgages at interest rates somewhat below market. The trust's main objectives are (a) alleviating a severe housing shortage by making affordable housing available and (b) having an immediate impact on unemployment, by creating jobs in the construction industry. The latter is particularly important since the rate of unemployment in Puerto Rico has been over 20 percent, a rate far higher than any state.

Third, our government has recently announced a plan to establish a venture capital enterprise called the Puerto Rico Development Bank.[19] Its purpose is to provide venture capital to new enterprises in Puerto Rico. The Bank will start with $50 million in Sec. 936 funds on deposit with the Government Development Bank.

Altogether, the government of Puerto Rico has moved aggressively to use its Sec. 936 funds to promote economic development. The newest phase of Operation Bootstrap relies heavily on the existence of Sec. 936 tax benefits.

Caribbean Development

The Congressional debate on tax reform and concern with the federal deficit have not diminished the need and desire to assist with the development of our Caribbean neighbors. Puerto Rico is in an excellent position to further this objective. In fact, we have been formulating a program to promote the development of Caribbean economies without requiring increased federal expenditures.

One program already in operation is that run by the Government Development Bank of Puerto Rico. Under this program, the Bank gives preferential treatment to loan applications for projects which promise to contribute towards economic development in Puerto Rico and at the same time, promise to foster development in one or more Caribbean Basin Countries. Financing for this program is from funds of 936 Corporations on deposit in Puerto Rico. Currently, the Government Development Bank has earmarked $700 million for this purpose.[20] The loans will be low interest and long term.

One effective vehicle for achieving the dual objectives of the Bank's loan program is to establish "twin plants". These are feasible where manufacturing can be economically segmented between two or more locations. Plants established in Caribbean countries undertake the highly labor-intensive operations that are no longer competitively done either in the States or in Puerto Rico, while plants in Puerto Rico specialize in operations requiring more skilled labor or greater capital intensity.

At present, there are several twin plants in operation. They are common in the apparel industry. An example is the case of textiles being shipped from the States to Puerto Rico for cutting. The cut fabric then is sent to a twin plant in Haiti or the Dominican Republic for assembly. Similarly, there are proposals for finishing and packaging Puerto Rican made pharmaceuticals in Costa Rica and for incorporating into computer components integrated circuits that have been assembled in Barbados. A total of 22 committments have been received so far.[21]

With twin plants, all three areas -- the States, Puerto Rico, and the Caribbean -- can gain employment and income. And this can be accomplished without the infusion of U.S. aid. What is required, however, is that the tax credit provisions of IRS Sec. 936 be retained.

CONCLUSION

It is quite clear to us, based on the intensive studies I have described and on Puerto Rico's recent experience with changes in Sec. 936, that should Congress modify Sec. 936 as proposed by the U.S. Treasury Department, the burden will fall most heavily on the people of Puerto Rico. While the States will suffer, also, Americans here will derive some offsetting benefits from your tax reform. We in Puerto Rico, with our own tax system, will realize no advantages. Nor is it likely that we can remedy the harm you can inflict. While your economy revived briskly from the last recession, ours has recovered only partially. Business investment in Puerto Rico is stagnant; the unemployment rate is more than double that of the States; and the social problems which have ensued are extraordinary.

Now comes Treasury's recommendation to reduce the investment incentives Sec. 936 provides. The disinvestment process in Puerto Rico, which will follow, will be stimulated by lower wages and tax and relocation incentives extant in other countries. Since our economic stage is much closer to that of developing countries than are the economies of the States, a much larger proportion of our industry is susceptible to relocation. Yet, we do not have the authority to stem the loss through trade or monetary policies. We must operate under policies established to meet the needs of the United States as a whole.

With reduced ability to restructure and revitalize our own economy, we shall be in no position to further the United States objectives in the Caribbean through economic assistance to our neighbors. Our value to you both politically and militarily will be diminished.

As President of the Commonwealth's Senate, I find it difficult to believe that Congress will sacrifice meaningful incentives for investment in Puerto Rico for the benefit of deriving meager revenue from relatively few corporations. If there still are abuses of Sec. 936, as alleged, let us work together to eliminate them. Let us not destroy the opportunity to have Puerto Rico serve as a critical element in the political and economic development of the Caribbean.

On behalf of the Senate of Puerto Rico and the people we represent, thank you for inviting me to present our views. Your consideration of our position is deeply appreciated.

Source Notes

[1] United States Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Fifth Annual Report (July 1985).

[2] Fernando Zalacaín, "Impact on the United States Economy of'936 Corporations' Operating in Puerto Rico", paper prepared for the Senate of Puerto Rico (September 1985), at 1.

[3] Supra note 1, Third Annual Report (June 1980), at 51.

[4] These are Type II multipliers which are larger than Type I. See supra note 2, at fn.6.

[5] Supra note 2, at 9.

[6] Theodore Lane, Economic Development Administration, Government of Puerto Rico, "The Impact of Repealing 936 on the Puerto Rican Economy" (January 1985), at 7.

[7] Supra note 2, at 4-9.

[8] This figure is net of the workers that would be employed by 936 firms relocating in the United States as well as the indirect jobs these firms would generate.

[9] ICF Incorporated, "Benefit-Cost Analysis of Section 936", prepared for Economic Development Administration, Commonwealth of Puerto Rico (September 1985), Table 4.

[10] Id., items 2,5, and 6.

[11] Id., items 3,4,7,9, and 10.

[12] Id., Table 2.

[13] Id., Table 1.

[14] ICF Incorporated, "Data and Assumptions Use: Benefit-Cost Analysis of Section 936", prepared for Economic Development Administration, Commonwealth of Puerto Rico, (September 1985), at 4.

[15] Supra note 1, at 64.

[16] Supra note 9, at 8.

[17] Id., at 8.

[18] "Government Development Bank Crates Mortgage Trust", 10 Puerto Rico Business Review 1 (April 1985), at 1.

[19] ICF Incorporated, "The Twin Plant Concept in Caribbean Basin Development", prepared for Economic Development Administration, Commonwealth of Puerto Rico (September 1985), at I-2.

[20] Id., at I-2.

[21] Id., at 4-6 and Ex. 4-1.

STATEMENT OF DAVE J. SANTOS, DIRECTOR OF REVENUE AND TAXATION, TERRITORY OF GUAM, ON BEHALF OF HON. RICARDO J. BORDALLO, GOVERNOR, TERRITORY OF GUAM

The CHAIRMAN. Mr. Santos.

Mr. SANTOS. Mr. Chairman, members of the Senate Finance Committee, my name is Dave J. Santos, director of the Department of Revenue and Taxation for the Territory of Guam of the United States of America. On behalf of Governor Bordallo and the people of Guam, I thank you for the opportunity to present my views concerning the reform of the mirror system of taxation as it applies to the territory of Guam.

Since 1950, Guam has administered and enforced the income tax laws of the United States through its Organic Act. This section was enacted by the Congress primarily to relieve the Federal Government of making direct appropriations to the Government of Guam. Although Congress delegated the administration and enforcement function of the Federal tax system to the local government, the territory is powerless to vary the terms of the Internal Revenue Code as applied to Guam except as permitted by the Congress.

The difficulties with this narrow tax system have been documented many times. One of the best discussions is found in an article by Karla Hoff entitled: "U.S. Federal Tax Policy Toward the Territories: Past, Present and Future." This appeared in the Tax Law Review Publication, Volume 37, No. 1 in 1981. We have attached a copy of this article for your review.

Rather than restate the material in that article, I would point out the single most burdensome aspect of the mirror image to Guam. And, that is, revenue instability. The Congress is continually changing U.S. tax laws. In the last 10 years, major changes occurred in 1976, 1978, 1981, 1982 and most recently in 1984. And a further revision is now under consideration.

Congressional action dramatically affects Guam's revenue. This makes it virtually impossible to do any long-term financial planning. Even when proposals are set to be revenue neutral, they are not neutral in Guam. Our per capita income is less than that of any State in the union. Reforms which reduce the burden of low income taxpayers, but provide compensating revenue for middle and upper taxpayers, erode our tax base since we have a larger proportion of low income taxpayers than that in the 50 States. In fact, 95 percent of Guam's taxpayers have an annual adjusted gross income of under $40,000.

Also, the complexities of the mirror image system make tax administration in Guam most difficult. Our island contains roughly 110,000 people. Apart from the Commonwealth of the Northern Marianas, we are literally thousands of miles from the nearest U.S. tax jurisdiction, approximately 9,000 miles from Washington, DC.

It is simply not possible to support a staff with the experience and knowledge of the more specialized portions of the U.S. Tax Code with such a population base. As a result, we must concentrate on general issues.

I'd like to divert from this canned presentation to say that I think one of the reasons why in the past Guam has not pursued delinking from the U.S. Internal Revenue Code is based on two reasons. Even when Guam was granted U.S. citizenship back in 1950, there was imposed a security blanket for 12 years following that by the U.S. military so that people who wanted to leave Guam—and these are American citizens—or to enter Guam must get permission from the Naval Administration. And it was only 8 years after that that Congress allowed Guam to elect its first Governor. Given that, there has been no real private sector growth in the early 1960's until the late 1960's and early 1970's. And as a result of our efforts to attract offshore investors, we found problems in our code. Forty-six percent corporate rates are not competitive with the rest of our Pacific Asian rim neighbors.

I should also note that the President's delinkage proposal for Guam is supported by the Western Governors Association and is entirely consistent with the language contained in Guam's draft Commonwealth Act, which shall be presented to this Congress at a later date.

For all these reasons we strongly support the President's proposal to eliminate the mirror image system and to restore to Guam its rightful power to levy its own taxes. Since the development of a local tax system will take time, we propose to continue the application and enforcement of the U.S. Internal Revenue Code in Guam in its present form. Proposed reduction in tax rates and increases in amounts for personal exemptions, as outlined in other chapters of the President's proposal, is estimated to cost Guam over $23 million, if adopted in 1986. It is, therefore, important that the Congress permit Guam to delink from the Internal Revenue Code and adopt the pre-reformed code as an interim system at least to maintain revenue neutrality.

In anticipation of favorable congressional action on this issue of delinkage, the Governor has established a tax review committee representing a good cross section of the community. Government officials, business leaders, legal and accounting professionals and other interested individuals form the core of this committee, with myself as chairman. The committee has been meeting regularly, formulating transitional plans and recommendations for the territory's interim and future tax system. We are confident that the Tax Code eventually presented to the people of Guam will be fair and consistent with the territory's economic goals and objectives.

We ask that you favorably consider this important provision and the President's proposal so that Guam can more efficiently and effectively develop itself into an economically self-sufficient territory.

Thank you.

The **Chairman**. Thank you.

[The prepared written statement of Hon. Ricardo J. Bordallo follows:]

TESTIMONY
OF
THE HONORABLE RICARDO J. BORDALLO
GOVERNOR OF GUAM

PRESENTED BY

DAVE J. SANTOS

DIRECTOR, DEPARTMENT OF REVENUE & TAXATION

GOVERNMENT OF GUAM

BEFORE THE SENATE COMMITTEE ON FINANCE

UNITED STATES CONGRESS

CONCERNING THE IMPACT ON REGULATED INDUSTRIES AND PROVISIONS RELATING TO U.S. POSSESSIONS AND TERRITORIES

03 OCTOBER 1985

Mr. Chairman and Members of the Senate Finance Committee, my name is Dave J. Santos, Director of the Department of Revenue and Taxation of the Territory of Guam, U.S.A. On behalf of the Governor and the People of Guam, thank you for the opportunity to present our views concerning the reform of the "mirror" system of taxation as it applies in the Territory of Guam.

Since 1950 Guam has administered and enforced the income tax laws of the United States as mandated by Section 31 of the Territory's Organic Act. This section was enacted by the Congress primarily to relieve the Federal Government of making direct appropriations to the Government of Guam. Although Congress delegated the administration and enforcement function of the Federal income tax system to the Government of Guam, the Territory is powerless to vary the terms of the Internal Revenue Code as applied to Guam, except as permitted by the Congress.

The difficulties with this mirror tax system have been documented many times. One of the best discussions is found in an article by Karla Hoff entitled, "U.S. Federal Tax Policy Towards the Territories: Past, Present and Future" which appeared in the Tax Law Review, Volume 37, No. 1 for 1981. I have attached excerpts of that article to my testimony for the Committee's reference.

Rather than restate the material in that article, I would point out the single most burdensome aspect of the mirror image to Guam - revenue instability. The Congress is continually changing U.S. tax laws. In the last ten years, major changes occurred in 1976, 1978, 1981, 1982 and 1984, and a further revision is now under consideration. Congressional action dramatically affects Guam revenue. This makes it virtually impossible to do any long-term financial planning. Even when proposals are said to be "revenue neutral", they are not neutral for Guam. Our per capita income is less than that of any state in the union. Reforms which reduce the burden on low income taxpayers but provide "compensating revenue" from middle and upper taxpayers erode our tax base since we have a larger proportion of low income taxpayers then on the U.S. Mainland. In fact, 95% of Guam's taxpayers have annual adjusted gross incomes of under $40,000.00.

Also, the complexities of the mirror image system make tax administration on Guam most difficult. Our island contains roughly one hundred and ten thousand people. Apart from the Commonwealth of the Northern Marianas, we are thousands of miles from the nearest U.S. tax jurisdiction. It is simply not possible to support a staff with the experience and knowledge of the more specialized portions of the U.S. tax code with such a population base. As a result, we must concentrate on general issues.

I should also note that the President's delinkage proposal for Guam is supported by the Western Governors' Association and is entirely consistent with the language contained in Guam's draft Commonwealth Act which shall be presented to this Congress.

For all these reasons, we strongly support the President's proposal to eliminate the "mirror image system" and to restore to Guam its rightful power to levy its own taxes.

Since the development of a local tax code will take time, we propose to continue the application and enforcement of the Internal Revenue Code on Guam in its present form.

Proposed reductions in tax rates and increases in amounts for personal exemptions as outlined in other chapters of the President's proposal is estimated to reduce Guam's revenue base by over $23 Million if adopted in 1986. It is, therefore, important that Congress permit Guam to de-link from the Internal Revenue Code and adopt the pre-reform code as an interim tax code to maintain revenue neutrality.

In anticipation of favorable Congressional action on this issue of delinkage, the Governor has established a Tax Review Committee representing a good cross-section of the community. Government officials, business leaders, legal and accounting professionals and other interested individuals form the core of this Committee with myself as Chairman. The Committee has been meeting regularly formulating transitional plans and recommendations for the Territory's interim and future tax system.

We are confident that the tax code eventually presented to the people of Guam will be fair and consistent with the Territory's tax reality, economic goals and objectives. We ask that you favorably consider this important provision of the President's proposal so that Guam can more efficiently and effectively develop itself into an economically self-sufficient Territory.

Thank you very much for allowing me to appear before you.

U.S. Income Tax Relationship With Guam

Historical Background

Although the United States acquired Guam from Spain in 1898, Guam was not granted self-government until 1950. In the interim, a succession of naval governors exercised sole responsibility for the administration of the island, pursuant to a two-line executive order of President McKinley.[144] The naval governors received periodic appropriations from Congress. U.S. internal revenue laws were not locally applicable. In 1950, Congress granted a measure of self-government to the people of Guam and made all native Guamanians U.S. citizens.[145] The Organic Act of 1950 provided for a locally elected legislature and a governor appointed by the President.

Once the elected officials of Guam had the right to draw up Guam's

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the U.S. market. Since U.S. internal revenue laws do not, in general, directly apply to Puerto Rico or to the Virgin Islands, U.S. taxes on production do not reach goods produced in the islands. U.S. sales taxes, on the other hand, reach all goods sold within the United States and, thus, sales taxes do not have counterpart equalization taxes.

[140] Brief for Appellant at 1–16 (both cases).

[141] 642 F.2d at 566–626.

[142] 642 F.2d at 632–633.

[143] *Ibid.*

[144] Executive Order No. 108–A (1898).

[145] Organic Act of Guam, ch. 512, § 4(a) 64 Stat. 384 (1950) (8 U.S.C. §§ 601–05).

budget. Congress expected the residents to finance the local government, other than the salaries of federal appointees. During debate on the proposed Organic Act, one congressman stated that there were "sufficient sources of revenue right there on the island of Guam so that they will be able to set up a tax structure sufficient to carry their own expenses of government without asking for any contribution from the United States to help carry their government cost."[146]

In 1950, Guam had a population of 96,000, of whom 26,000 were native Guamanians and most of the remainder were members of the U.S. armed forces or employees of U.S. government contractors. An economic boom was in progress as a result of war reconstruction. Much of the income, however, escaped taxation. The U.S. tax jurisdiction did not extend to citizens of Guam (not otherwise citizens of the United States),[147] or to foreign nationals and foreign corporations deriving income from Guam, since the Code defined the United States to include only the states, the District of Columbia and the territories of Alaska and Hawaii.[148] U.S. citizens and U.S. corporations deriving their income primarily from Guam were likewise exempt from federal income taxation under a provision enacted in 1921 to alleviate the competitive disadvantage of U.S. businessmen relative to foreign businessmen in the Philippines and other U.S. possessions.[149]

To close the "loophole" through which persons in Guam escaped all income tax,[150] Congress provided in a rider to the Organic Act that "[t]he income tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in Guam."[151] Another section of the Organic Act provided that "[a]ll customs duties and Federal income taxes derived from Guam . . . shall be covered into the treasury of Guam."[152]

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[146] 96 Cong. Rec. 7577 (1950) (remarks of Rep. Scrivner and Rep. Miller).

[147] Revenue Act of 1918, ch. 78, § 260, 40 Stat. 1087 (1919) (reenacted as section 252 of the Internal Revenue Code of 1939 and, as amended, I.R.C. § 932). See N. 37 *supra*.

[148] *Id.* § 1 (reenacted as section 3797(a)(9) of the Internal Revenue Code of 1939).

[149] Section 252 of the Internal Revenue Code of 1939 (restated as I.R.C. § 931). The exemption currently applies only to U.S. corporations doing business in the possessions under I.R.C. § 936.

[150] 96 Cong. Rec. 7577 (1950) (remarks of Rep. Miller).

[151] Organic Act of Guam, ch. 512 § 31, 64 Stat. 392 (1950) (current version t 48 U.S.C. 1421(i) (Supp. 1979)).

[152] *Id.* § 30 (codified in 48 U.S.C. 1421(h) (1976)). This section also pro-ided that U.S. internal revenue taxes on goods produced in Guam and transported o the United States shall be deposited into the treasury of Guam. The amount f taxes covered over pursuant to this section was small in 1950, and today is zero, s no goods entering the United States from Guam are currently subject to a fed-ral manufacturer's excise tax. See Virgin Islands Report, *supra* N. 71, at 17.

The legislative history of the Organic Act suggests that the payment of federal taxes derived from Guam into the Guamanian treasury was intended to be a temporary measure. Thus, the following statement appears in a 1954 report by the Senate Committee on Interior and Insular Affairs:

> [A]t the time of the hearings on the Organic Act for Guam in 1950 (Public Law 630, 81st Cong.) we were assured by the Governor of Guam, with the acquiescence of the representatives of the Territorial legislature,[[183]] that if all the taxes either from incomes of persons on Guam or products or activities originating in Guam, were granted to the insular treasury for a period of 2 years, the island could become self-supporting. Those 2 years have become 4 years and, in the pressure of business and activity in the Senate, nothing has been done about determining whether Guam is or is not self-supporting without the prop of revenues which other American citizens have to pay to support their Federal Government.[184]

No determination was made and, in the meantime, controversy arose as to whether the United States or Guam had authority to administer the U.S. income tax laws in force in Guam. Guam had proceeded to collect the U.S. income tax imposed on its residents after 1950, and numerous suits for refund were filed.[185] To ratify the assessments and collections that Guam had made, Congress in 1958 enacted legislation "clarifying" the meaning of section 31 of the Organic Act. Public Law Number 85–688 provided that the U.S. income tax laws as applicable to Guam under section 31 of the Organic Act imposed "a separate Territorial income tax," administered by the government of Guam.[186] In order to obtain a "mirrored effect" between the federal and Guamanian income taxes, Congress provided that "except where it is manifestly otherwise required, the applicable provisions of the Internal Revenue Codes of 1954 and 1939 shall be read so as to substitute 'Guam' for 'United States.' "[187]

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[183] The Congress of Guam dated back to 1917, although it exercised only an advisory role before 1950. H.R. Rep. No. 1677, 81st Cong., 2d Sess. 9 (1950).

[184] Virgin Islands Report, *supra* N. 71, at 18. This statement by the Governor of Guam is also referred to in S. Rep. No. 2109, 81st Cong., 2d Sess. 15 (1950).

[185] *See, e.g.*, Jennings v. United States, 155 F. Supp. 571 (Ct. Cl. 1957); Laguana v. Ansel, 102 F. Supp. 919 (D. Guam 1952), *aff'd per curiam*, 212 F.2d 207 (9th Cir. 1954).

[186] 48 U.S.C. §§ 1421i(b) and (c) (1976).

[187] 48 U.S.C. § 1421i(e) (1976). *See also* H.R. Rep. No. 2273, 85th Cong., 2d Sess. 5–6 (1958).

Status of U.S. Persons Under U.S. Tax Law Applicable in Guam

The result of Public Law Number 85–688 was to establish in Guam an income tax system which incorporated virtually all of the pitfalls of the Virgin Islands income tax. By codifying the language substitution system (which is the basis of the mirror system), it provided that Guam would tax U.S. nationals under U.S. law as though they were foreign persons.[158] In general, the courts upheld the tax consequences that follow from the mirror system.[159]

Beginning in 1968, representatives of the Virgin Islands and Guam met with U.S. representatives to work out a way to remove the anomalies created by the mirror systems. This task force's product—legislation passed in 1972—substantially modified the application of the Guam mirror system to individuals.[160] From the perspective of the individual taxpayer, Guam became a collection district of the United States, identical for most U.S. income tax purposes to a stateside collection district. Under new section 935, a resident of the United States or Guam is required to file only one tax return—with Guam if he is resident there on the last day of the year, or with the United States if he is resident in one of the 50 states or the District of Columbia on the last day of the year.[161] For purposes of computing the individual's tax liability, section 935 provides that domestic source income shall include income derived from sources within either the United States or Guam.[162] In the event that an individual is resident in Guam for only a part of his tax year and resident in the United States for another part of the year, section 935 allows full credit for taxes paid to or withheld by both jurisdictions without regard to the foreign tax credit limitation.[163] Thus, income taxes withheld by one jurisdiction can be claimed as a credit in the jurisdiction where the individual files his return, just as if the taxes had been withheld by the jurisdiction of residence.[164]

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[158] See the text accompanying Ns. 94–95 *supra*.

[159] *See, e.g.*, Sayre & Co. v. Riddell, 395 F.2d 407 (9th Cir. 1968); Government of Guam v. Koster, 362 F.2d 248 (9th Cir. 1966). However, the mirror theory was not applied in Atkins-Kroll (Guam) Ltd. v. Government of Guam, 367 F.2d 127 (9th Cir. 1966), *cert. denied*, 386 U.S. 993 (1967). These cases were later relied upon by the Third Circuit in cases involving the income tax in the Virgin Islands.

[160] Pub. L. No. 92–606, 86 Stat. 1494 (1972). This legislation did not modify the mirror system as it applied to corporations, except with respect to the 30 percent flat tax imposed under I.R.C. § 881 on "domestic" source investment income paid to "foreign" corporations. The legislation added new section 881(b) to the Code to provide that a Guam corporation would not be treated as a foreign corporation for purposes of that section. Mirroring that provision into Guam tax law, section 881(b) provides that a U.S. corporation will not be treated as a foreign corporation for purposes of the Guam tax imposed under section 881. The explanation for this exemption was that Congress wished to promote U.S. investment in Guam. H.R. Rep. No. 92–1479, 92d Cong., 2d Sess. 2–3 (1972).

[161] I.R.C. § 935(b).

[162] I.R.C. § 935(c).

The 1972 legislation preserved Guam's claim, originally in section 30 of the Organic Act of Guam,[165] to the federal income taxes paid by U.S. military employees stationed in Guam. Such individuals are, in general, not taxable directly by Guam.[166] The legislation added new section 7654(d) to the Code, requiring that the Secretary of the Treasury pay to Guam the taxes withheld by the United States with respect to the compensation of military personnel based in Guam—currently somewhat less than $15 million per year.[167]

The 1972 legislation eliminated the perceived inequities and legal uncertainties in the taxation of U.S. citizens subject to income taxation in Guam, but it gave rise to new problems in the division of revenues between the United States and Guam.[168] The legislative history of section 935 suggests that Congress intended to provide Guam the exclusive right to tax full-year residents of Guam.[169] Section 935(c)(3) is categorical: residents of Guam are hereby "relieved of liability" for the United States income tax. However, the 1972 law did not make federal tax withholding obligations consistent with the liability rules set down in section 935(c)(3), nor (as an alternative) did it provide a comprehensive mechanism for the federal government to pay these taxes into the Guamanian treasury. Inconsistencies exist in three areas:[170]

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[163] Reg. § 1.935-1(b)(1).

[164] At the time the Guam bill was enacted, the Joint Committee on Taxation and the Assistant Secretary of the U.S. Treasury expressed the hope that the provisions of the legislation could eventually be extended to cover the United States-Virgin Islands income tax relationship as well. However, the Virgin Islands did not wish to adopt the new scheme because it would have provided that U.S. residents with an unincorporated Virgin Islands business were taxable only by the United States. In addition, the Virgin Islands did not wish to give up the 30 percent withholding tax on direct U.S. investment in the Virgin Islands. A major advantage of the proposal to Guam—elimination of the dual filing requirement for Guam residents with U.S. source income—did not provide any benefit to the Virgin Islands, which had already obtained a single filing rule for its inhabitants under section 28(a) of the Revised Organic Act of the Virgin Islands of 1954 (current version at 48 U.S.C. § 1642 (Supp. 1979)).

[165] Section 30 of the Organic Act of Guam, ch. 512, 64 Stat. 392 (1950), provides, in pertinent part: "Federal income taxes derived from Guam . . . shall be covered into the Treasury of Guam." This provision of section 30 was superseded by I.R.C. §§ 935 and 7654. *See* Reg. § 301.7654-1(a).

[166] The Soldiers and Sailors Civil Relief Act, 50 U.S.C. § 574 (1976) provides, in relevant part: "[A] person shall not be deemed to have lost a residence or domicile in any State, Territory [or] possession . . . solely by reason of being absent therefrom in compliance with military or naval orders, or to have acquired a residence or domicile in any other State, Territory [or] possession . . . while, and solely by reason of being, so absent. For the purposes of taxation in respect of the . . . income or gross income of any such person by any State, Territory [or] possession . . . of which such person is not a resident or in which he is not domiciled, compensation for military or naval service shall not be deemed income for services performed within, or from sources within, such State, Territory [or] possession."

[167] For 1981, the *Appendix to the Budget of the United States Gov't* (fiscal year 1982), at I-M69, reports that Guam received a total of $18.9 million in U.S. income taxes withheld from the compensation of U.S. government *civilian* and *military* employees for services performed in Guam. No breakdown of the amounts is available. For the authority for the payment to Guam of U.S. taxes withheld from the compensation of federal civilian employees in Guam, see the text accompanying Ns. 169-71 *infra*.

> (1) The United States withholds tax on compensation paid to U.S. government employees in Guam. Currently, these withholding taxes are covered over to Guam pursuant to a 1973 Treasury recommendation to the Internal Revenue Service to continue to cover over these withholding taxes as if section 30 of the Organic Act had not been fully superseded.
>
> (2) The United States withholds (and retains) tax on pension payments to retired military and civil service employees resident in Guam.
>
> (3) The United States withholds (and retains) tax on compensation paid to residents of Guam serving in the U.S. armed forces.

In 1980, the legislature of Guam petitioned Congress to end the "inequitable division of tax revenues between the United States and Guam."[171] The U.S. Treasury indicated to the government of Guam that, if necessary, it would be prepared to seek statutory clarification.[172]

Opportunities for Federal Tax Evasion and Avoidance

In addition to the interpretative questions raised by the federal income tax relationships with the Virgin Islands and Guam, these relationships create numerous opportunities for federal tax avoidance and evasion. Such opportunities arise from the fragmentation of tax jurisdiction over U.S. taxpayers and from the failure of particular U.S. tax provisions to take account of the special status of the Virgin Islands and Guam.

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[168] *See* TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 22.

[169] H.R. REP. No. 92-1479, 92d Cong., 2d Sess. 4 (1972). However, a separate rule was adopted requiring certain high-income individuals to report the respective amounts of their income from Guam and the United States so that the tax collections on such persons could be prorated between the two jurisdictions. I.R.C. § 7654(a); see I.R.C. § 6688.

[170] *See* TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 22.

[171] Res. 433, 15th Guam Legislature (1979).

[172] TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 23.

Under the Virgin Islands mirror system, a U.S. citizen or a U.S. corporation that claims residence in the Virgin Islands can earn U.S. source income without having to pay federal income tax or file a federal income tax return. Under the Guam mirror system, an individual who claims residence also has no obligation to file a U.S. tax return. Although residents of a territory are required to pay tax on their worldwide income under the U.S. income tax laws administered by the territory, individuals have an incentive to make claims to territorial residence because the Virgin Islands and Guam do not have the resources nor, apparently, the political will to enforce the Code.[173] One senior official of the Guamanian tax department recently listed 15 different areas of the tax law, including consolidated returns, corporate distributions and source of income rules, of which no employee of the tax department had any knowledge. The U.S. Treasury has noted this means of evading federal tax and the fact that "the IRS is not well positioned to prevent the evasion of U.S. taxes by individuals with dubious claims to residence in a territory." [174]

An individual who does change residence from the United States to the Virgin Islands or Guam, or vice-versa, may attempt to change accounting methods in order to minimize tax. The tax savings could be substantial where, for example, a cash basis taxpayer has realized a gain on a sale and is reporting the gain on the installment method.[175] After the taxable year of the installment sale, the taxpayer could change his residence from, say, the Virgin Islands to the United States. The installment sale seemingly would insulate the amounts received in subsequent years from Virgin Islands tax provided that the seller, a nonresident alien with respect to the Virgin Islands, does not engage in a trade or business in the Virgin Islands in subsequent years when installment payments are received.[176] Upon filing his first return with the United States, the taxpayer could adopt the accrual method and take the reporting position that all of the gain on the transaction was recognized in the year of sale. Although such a change in accounting methods is presumably contrary to law,[177] the difficulty of discovering the change undermines federal tax administration.

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[173] See letter from Elmer Staats, Comptroller General of the United States, to Representative Morris Udall (Oct. 3, 1979).

[174] Territorial Income Tax Systems, *supra* N. 7, at 40.

[175] I.R.C. § 453. *See* Berney, *Transfer of Installment Obligations to the U.S. Virgin Islands*, 7 Int'l Tax J. 229 (1981).

[176] Reg. § 1.871–8(c)(1) (as mirrored into the Virgin Islands tax law).

[177] Under section 28(a) of the Revised Organic Act of the Virgin Islands of 1954 (current version at 48 U.S.C. § 1642 (Supp. 1979)), an inhabitant of the Virgin Islands satisfies his income tax obligations to the United States by paying income taxes to the Virgin Islands. Therefore, when he changes his residence from

Federal law requires the Virgin Islands and Guam to collect the tax due under the locally applicable U.S. income tax laws, but generally it does not prohibit the territories from rebating the taxes collected.[178] Tax incentive legislation adopted by the legislatures of the Virgin Islands and Guam allows a rate reduction of up to 100 percent of the otherwise applicable 46 percent rate for qualifying businesses.[179] A corporation which is an "inhabitant of the Virgin Islands" or a "possessions corporation" will avoid paying tax to the United States, as well.[180] A U.S. parent corporation can, in turn, offset a dividend received from a wholly-owned U.S subsidiary in the territory with a 100 percent dividends received deduction, which removes the dividend income from federal tax.[181] The ability of a U.S. parent-U.S. subsidiary together to escape tax on the income of the subsidiary in the territory creates a strong incentive for artificial profit-shifting by U.S. corporations to the territories. The U.S. Treasury has noted that "U.S. parents commonly lease plant and equipment to their territorial affiliates, which may have the effect of artificially inflating the income

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the Virgin Islands to the United States, he is arguably not a "first filer." Any change in accounting methods is thus subject to the requirements of the treasury regulations, which provide that the taxpayer must obtain the approval of the Commissioner for the change, and that he make all necessary adjustments to his return to ensure that the change in accounting methods does not result in the omission of any item of income. Reg. §§ 1.446-1(c)(2)(ii) and 1.446-1(c)(3)(i).

For the argument that this tax avoidance technique is legitimate, see Berney, *supra* N. 175, at 229-236, and Danielson, *supra* N. 7 at A-33.

[178] In Ramsey v. Chaco, 549 F.2d 1335 (9th Cir. 1977), the Ninth Circuit held that provisions of Guam law granting income tax rebates to eligible investors are not violative of section 31 of the Organic Act, since failure to annul the original rebate bill within one year of its submission to Congress constituted an implied congressional approval under the then existing provision of the Organic Act. In the case of the Virgin Islands, the right to rebate income taxes is limited by I.R.C. § 934, providing that income tax rebates may be granted only with respect to Virgin Islands source income, and that a recipient of an income tax rebate must be either an individual resident of the Virgin Islands or a corporation that derives 80 percent or more of its gross income from the Virgin Islands and 50 percent or more of its gross income from the active conduct of a trade or business in the Virgin Islands.

[179] V.I. Code Ann. tit. 29, ch. 12; Guam Civ. Code §§ 53577-79. *See also* Washington Post, June 22, 1981 (Washington Business), at 17. The amount of income taxes rebated by the Virgin Islands from 1973 through 1979 was $167 million, or 55 percent of corporate taxes collected under the Internal Revenue Code. (U.S. Gov't Comptroller for the Virgin Islands.) The tax incentive legislation of the Virgin Islands and Guam provides tax benefits comparable to those offered by Puerto Rico under its Industrial Incentive Acts. See U.S. DEP'T OF TREASURY, THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION, 3d Ann. Rep. (1980).

[180] 48 U.S.C. § 1642 (Supp. 1979); I.R.C. § 936.

[181] I.R.C. § 243.

will be deemed income effectively connected with a U.S. trade or business:

> (1) gain realized by a foreign corporation or nonresident alien from the disposition of an interest in U.S. real property, and
>
> (2) gain realized by a foreign shareholder on his interest in a U.S. corporation if half or more of the corporation's real property and business assets consists of U.S. real property.

FIRPTA also limited the ability of a foreign corporation to distribute an interest in U.S. real property without recognizing gain, or to avail itself of the benefits of a tax-free sale incident to liquidation under section 337.[186] This legislation was a response to political pressure to close the loopholes that until 1980 permitted foreigners who invested in U.S. farmland and other U.S. real estate to escape federal tax on their capital gains.[187]

Tax practitioners discovered that FIRPTA can be circumvented by forming a Virgin Islands corporation to hold U.S. real property. Such a corporation avoids taxation under section 897 by virtue of the Revised Organic Act of the Virgin Islands, pursuant to which inhabitants of the Virgin Islands satisfy their U.S. tax obligations by paying tax to the Virgin Islands.[188] By means of a sale of the real estate and liquidation under section 337 of the mirrored Virgin Islands Code, the Virgin Islands corporation can avoid tax liability to the Virgin Islands on gain from the sale of U.S. real estate. The benefits of a tax-free liquidation under section 337 are available to the Virgin Islands corporation because, with respect to the Virgin Islands, it is a domestic corporation. The foreign shareholders' capital gain on the disposition of their stock in the Virgin Islands corporation, upon liquidation or otherwise, is in turn exempt from both U.S. and Virgin Islands taxes. Section 897 of the Code does not apply to shareholders of a corporation chartered outside the United States; and the Virgin Islands mirrored Code does not apply to gain realized on U.S. real estate or stock of specified corporations, but rather to gain from Virgin Islands real estate or stock of certain Virgin Islands corporations.[189]

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[186] I.R.C. § 897(d).

[187] See *Hearings on S. 192 and S. 208 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on June 25, 1979* (statement of Donald C. Lubick, Assistant Treasury Secretary for Tax Policy); Feder & Parker, *The Foreign Investment in Real Property Tax Act of 1980*, 34 TAX LAW. 547 (1981); U.S. DEP'T OF TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (1979).

[188] See the text accompanying Ns. 73–75 *supra*.

The administration became aware of this loophole in FIRPTA in time to close it through technical corrections enacted as part of the Economic Recovery Tax Act of 1981.[190] A U.S. real property interest under section 897 was redefined as "an interest in real estate located in the United States or the Virgin Islands." Under this definition, a foreign shareholder of a Virgin Islands corporation will be subject to tax on gain on the disposition of U.S. or Virgin Islands real property under the mirrored section 897. The amendment further provides that a person subject to tax because of section 897 will pay that tax and file the necessary returns with the United States with respect to a direct interest in U.S. real property or an interest in a U.S.-chartered corporation, and with the Virgin Islands with respect to an interest in Virgin Islands real property or in a Virgin Islands-chartered corporation.[191]

As Congress continues to amend the Code, new opportunities for tax avoidance and evasion will arise as a result of the unique tax status of the Virgin Islands and Guam. Rarely do legislators recognize that separate taxing jurisdictions must interpret the Code in a mirrored image, and that an inhabitant of the Virgin Islands satisfies its U.S. income tax obligations on worldwide income by paying tax to the Virgin Islands under Code provisions applicable to domestic persons.

Does the United States-Territorial Tax Relationship Promote Territorial Fiscal Autonomy?

The historic rationale of the preferential tax arrangements for the Virgin Islands and Guam was to channel federal support to the territories in a way that would also promote territorial fiscal autonomy. The tax preferences were seen as an alternative to annual federal funding of territorial government operations. By enacting, in effect, 100 percent revenue sharing for taxes derived from the territories and, in addition, earmarking for the territories certain U.S. source revenues, Congress anticipated that the governments of the Virgin Islands and Guam would become self-sustaining.[192]

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[189] For the period that the Virgin Islands company is holding the U.S. real estate, it may pay dividends to its foreign shareholders and interest to its U.S. mortgagor without being subject to the requirement to withhold a 30 percent tax, provided that less than 20 percent of its gross income is derived from Virgin Islands sources. I.R.C. §§ 861(a)(1)(B), 862(a)(2)(A), 871(a), 881(a). The holding company would be subject to Virgin Island corporate tax on its worldwide income, but real estate corporations typically report losses for tax purposes, rather than positive taxable income. U.S. DEP'T OF TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (1979) (tables 2-3 through 2-5).

[190] Economic Recovery Tax Act of 1981, § 831(a) (codified at I.R.C. § 897(c)(1)(A)(i)).

[191] *Id.* § 831(f) (codified at I.R.C. § 6039C(f)).

In the 1950s and 1960s, these financing arrangements did accomplish the intended result. *Ad hoc* appropriations to the territories in these years were principally for disaster relief. In the 1970s, however, both the Virgin Islands and Guam accumulated large deficits. The Department of the Interior periodically warned that bankruptcy was imminent,[193] but after 1970, had no power to impose fiscal austerity.[194] To finance the territorial deficits, Congress appropriated special grants,[195] authorized federal financing bank loans,[196] and provided for prepayment to the Virgin Islands of the rum fund [197] and advance payment to Guam of income taxes withheld from members of the U.S. armed forces stationed there.[198] Table 1 shows that total *ad hoc* assistance between 1977 and 1980 amounted to $68 million for the Virgin Islands and $81 million for Guam.[199]

What went wrong? Table 1 suggests that demand for government

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[192] See the text beginning at Ns. 61, 119, 154 *supra*. See also 125 CONG. REC. 16894 (daily ed Nov. 16, 1979) (remarks of Sen. Johnston). The Virgin Islands and Guam are also eligible for approximately one half of federal grant-in-aid programs. See U.S. DEP'T OF INTERIOR, FEDERAL PROGRAMS AVAILABLE TO THE TERRITORIES OF THE UNITED STATES (1978).

[193] The July 1979 report of the Federal Comptroller for the Virgin Islands stated on page 5: "The financial condition of the Territorial Government continues to worsen at a rapid pace and is now at a point where a virtual bankruptcy situation could exist in the near future. . . . Potential sources of increased revenues do exist in amounts sufficient to reverse the trend of deficit spending." The August 1979 report of the Federal Comptroller for Guam stated on page i: "The Government of Guam's fiscal difficulties have grown more critical each year since 1974 . . . we anticipate that Guam could incur a cash shortfall of $30 million by the end of FY 80, unless immediate corrective measures are taken."

[194] In November 1970, the people of the Virgin Islands and Guam each elected their first governor. Since 1971, the Department of the Interior has exercised no direct control over the territorial governments. Virgin Islands Elective Governor Act, § 4, 48 U.S.C. § 1591 (1968); Guam Elective Governor Act, § 1, 48 U.S.C. § 1422 (1968).

[195] Many of these grants were to offset reductions in territorial tax revenues resulting from changes in the federal income tax. See the text accompanying Ns. 202–204 *infra*.

[196] 48 U.S.C. § 1574b (1976). Pub. L. No. 96–205, § 303, 94 Stat. 88 (1980) (to be codified at 48 U.S.C. § 1423a).

[197] 48 U.S.C. § 1645 (Supp. 1979).

[198] 48 U.S.C. § 1421h (Supp. 1979).

[199] Not included in this amount is the foregiveness of interest and principal on the $33 million balance of a loan owed by Guam to the U.S. government. Pub. L. No. 96–205, § 302, 94 Stat. 88 (1980); Pub. L. No. 96–597, § 201, 94 Stat. 3477 (1980).

Table 1

General Fund Expenditures, Income Tax and Income Tax Effort, and Federal *Ad Hoc* Assistance, 1971–1980[1]

(Dollars in millions)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
VIRGIN ISLANDS										
General Fund										
(1) Expenditures	76.5	91.8	104.1	110.1	121.9	128.3	124.8	135.1	149.0	*
(2) Operating surplus/deficit	(3.4)	2.6	(15.6)	(7.4)	(20.2)	(29.2)	(21.0)	(25.3)	(5.3)	*
Income Tax										
(3) Individual[2]	32.5	36.7	39.0	33.8	47.6	41.2	39.0	35.1	47.0	*
(4) Corporate[3]	15.2	19.9	14.8	27.4	14.7	10.1	19.8	17.0	*	*
(5) Total as percentage of gross territorial product[4]	18.1%	18.1%	13.6%	15.3%	13.6%	10.6%	11.3%	10.0%	*	*
Federal ad hoc assistance[5]										
(6) Grants	2.7[6]	2.7	2.7	2.7	3.7	2.7	8.3	14.5	0	49.0[7]
(7) Loans	0	0	0	0	0	0	22.0	0	9.0	0
GUAM										
General Fund										
(8) Expenditures	*	71.9	85.7	108.5	133.1	115.1	125.9	143.3	160.4	*
(9) Operating surplus/deficit	*	3.3	9.7	1.3	(20.1)	(19.9)	(3.6)	(10.3)	7.2	(21.6)[8]
Income Tax										
(10) Total revenues[3]	29.5	38.7	46.0	50.8	49.2	36.8	30.9	41.5	60.4	*
(11) Total as percentage of gross territorial product[4]	*	*	11.1%	11.0%	10.3%	7.7%	*	*	*	*
Federal ad hoc assistance[5] (excluding typhoon relief)							15.0	29.1	9.2	26.0[7]
(12) Grants	0	0	0	0	0	0				
(13) Loans	0	0	0	0	0	0	0	0	36.0	0

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* Not available

[1] Figures for federal assistance are on the basis of U.S. fiscal years. All other figures are on the basis of territorial fiscal years. Until 1979, the fiscal years of the Virgin Islands and Guam ended on June 30. Since 1979, territorial fiscal years have ended on September 30 (U.S. fiscal year). Figures for transition quarters are not shown.

[2] Net of refunds. The source documents show individual and corporate taxes on a gross basis and present only one figure for income tax refunds. That figure has been assumed to consist mainly of individual income taxes and has been deducted from them.

[3] Net of rebates, which averaged $22 million per year in the Virgin Islands and rose in Guam from approximately $100,000 in 1971 and 1972 to $4 million in 1977 and 1978.

[4] Computed on the basis of the average of the gross territorial product for the two calendar years straddled by the fiscal year.

[5] *Ad hoc* assistance includes all federal assistance for the territorial governments, other than grants-in-aid (which, in many cases, are available to the territories on the same basis as to the 50 states) and transfers of earmarked federal taxes.

[6] Between 1968 and 1976, annual payments of $2.7 million were made by Hess Oil Corporation to the Virgin Islands in consideration of a 14,000 barrel per day oil product import quota issued by the Secretary of the Interior in 1967.

[7] Includes $28 million in advance payments to the Virgin Islands of estimated federal taxes on V.I. rum shipments to the United States, and $16.3 million in advance payments to Guam of estimated U.S. income taxes withheld from federal goverment employees in Guam. The change in timing of the payment under Pub. L. No. 95-348 resulted in a double payment in fiscal year 1980, one half of which is counted as *ad hoc* federal assistance. See *Appendix to the Budget of the United States Government* (fiscal year 1982) at I-M69.

[8] Excess of General Fund appropriations as of April 11, 1980, over estimated General Fund revenues for fiscal year 1980.

Sources: Lines (1) and (2) are from U.S. Interior Department, U.S. Government Comptroller for the Virgin Islands, *Financial Condition of the Government of the Virgin Islands of the United States* (hereinafter, *V.I. Comptroller's Report*), various years. All years except 1979 shown in lines (3) and (4) are from Virgin Islands Department of Finance, *Annual Report on Financial Operations*, FY 1977 and 1978. The figure shown for 1979 is revenue less imputed reserve for income tax refunds reported in *V.I. Comptroller's Report, FY 1979*. Line (5) is based on gross territorial product statistics estimated by Jerome McElroy in V.I. Department of Commerce, "Comparative Growth Statistics." Lines (6) and (12) are based on *Budget of the U.S. Government*, various years, and Federal appropriation acts for the Interior Department. Lines (7) and (13) are from U.S. Treasury, Federal Financing Bank. Lines (8) and (9) are from U.S. Interior Department, U.S. Government Comptroller for Guam/TTPI/NMI, *Audit Report on the Fiscal Condition of the Government of Guam*, various years. All years shown in line (10) except 1971 and 1972 are based on revenues before rebates reported in U.S. Interior Department, U.S. Government Comptroller for Guam, *Audit Report of the Fiscal Condition of the Government of Guam*, annual reports. Gross revenues for 1971 and 1972 were provided by Government of Guam, Department of Revenue and Taxation, which was also the source of income tax rebates accrued under Guam's industrial incentive program. Line (11) is based on gross territorial product statistics estimated in Russell C. Krueger and Clara M. Okada, *The Gross Island Product of Guam*, Guam Department of Commerce, 1978.

services in the territories increased substantially, while resistance to taxation also increased. Despite a sharp rise in U.S. assistance and real economic growth during the 1970s,[200] the Virgin Islands and Guam incurred deficits in almost every year after 1972. Net income tax collections, the main source of local revenues in the Virgin Islands and Guam, were stagnant between 1972 and 1978 in dollar terms; in real terms they declined. As a percentage of Virgin Islands gross territorial product, Virgin Islands income taxes declined from 18 percent in 1971 and 1972, to 10 percent in 1978. In Guam, income taxes declined from 11 percent of gross territorial product in 1973 to less than 8 percent in the period from 1976 through 1978.

The Virgin Islands and Guam alleged that a major cause of their decline in income tax revenues was the reduction in individual income tax liabilities provided for by the *federal* revenue laws enacted each year between 1975 and 1978. Since the income tax laws of the Virgin Islands and Guam are "mirrors" of the Code, reductions in the U.S. income tax reduce the liabilities of taxpayers in the territories as well. The territories' lack of control over the locally applicable U.S. income tax laws became the justification for additional federal aid.[201] In 1976, the United States authorized a grant of $8.5 million "to compensate the Virgin Islands for the unexpected revenue loss occasioned by the Tax Reduction Act [of 1975]."[202] The next year, the United States authorized $14 million for the Virgin Islands and $15 million for Guam in order to offset "unexpected revenue losses occasioned by the Tax Reduction Act of 1975 and the Tax Reform Act of 1976."[203] In 1977, statutory tax rates were again reduced by the Tax Reduction and Simplification Act of 1977. Section 407 of the Act authorized payments to the Virgin Islands, Guam and American Samoa, in an amount equal to the loss to the territories with respect to tax returns for 1977 by reason of the reduction in statutory tax rates.[204] Pursuant to this provision, the United States appropriated a total of $6 million to the three territories combined.

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[200] *See* The Economy of the U.S. Virgin Islands, *supra* N. 127; Guam Dep't of Commerce, Statistical Abstract, recent years.

[201] The year 1975 was the first time that the Virgin Islands sought special grants to compensate for federal tax reductions. Guam did so for the first time in 1976.

[202] 48 U.S.C. § 1574d (1976). *See* S. Rep. No. 94–1021, 94th Cong., 2d Sess. 5 (1976).

[203] 26 U.S.C. § 7651 note (Supp. 1979).

[204] Tax Reduction and Simplification Act of 1977, § 407(a). American Samoa was included in this legislation because it had adopted the U.S. income tax laws, with certain modifications, as its local income tax law. See Territorial Income Tax Systems, *supra* N. 7, at 28–29.

Beginning in 1976, several members of Congress proposed that the loss to the Virgin Islands resulting from changes in the U.S. income tax laws warranted a permanent solution. The proposal was to deposit into the treasury of the Virgin Islands the U.S. excise taxes collected on past and future shipments of Virgin Islands gasoline to the United States.[205] This was the same result which the Virgin Islands sought after 1978 through the courts in *Virgin Islands v. Blumenthal.*[206] In a letter to the President, the Chairman of the House Subcommittee on National Parks and Insular Affairs wrote that the United States was "obligated" to provide additional federal assistance to the Virgin Islands, "since the Virgin Islands deficit has been directly caused by federal actions affecting tax revenues collected."[207] The Chairman went on to state that "since the Federal government has . . . provided some interim relief through partial reimbursement of these tax losses, it seems to me that we must also recognize our special obligation to provide the Virgin Islands with some kind of permanent solution."

The argument for make-up payments to offset reductions in federal tax rates was misleading for two reasons: First, the argument implied that changes in federal tax law reduced territorial welfare. It ignored the fact that the loss to the territorial treasuries was the gain of the territorial taxpayers. If the governments of the Virgin Islands and Guam preferred to maintain their revenues rather than have their taxpayers enjoy reduced tax liabilities, they could have offset reductions resulting from changes in the Code through increases in local taxes. Since 1976 and 1977, respectively, the Virgin Islands and Guam have also had the authority to levy income tax surcharges of up to 10 percent.[208]

Second, the argument for make-up payments presumed that the federal income tax reductions significantly reduced territorial revenues in real terms. In fact, the main effect of the changes in the federal individual income tax under the revenue acts of 1975, 1976, 1977 and 1978 was to offset the automatic tax increases that result from the tendency of inflation to subject individuals to higher tax rates.[209] On the basis of an analysis of both U.S. tax law and income distribution in the Virgin Islands,[210] the U.S. Treasury concluded that "[t]he tax law changes [between 1973 and 1978] could not be the sole or even the primary cause for the sharp decline in the ratio of tax collections to gross V.I. product after 1973." [211]

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[205] Three bills were proposed on behalf of the Virgin Islands that would have provided for the transfer of these taxes to the Islands through an amendment to I.R.C. § 7652. S. 2998, 94th Cong., 2d Sess. § 4; H.R. 6110, 95th Cong., 1st Sess. § 401(a) (1977); S. 2821, 95th Cong., 2d Sess. § 16(b) (1978).

[206] See the text accompanying Ns. 33–43 *supra*.

[207] Letter from Congressman Phillip Burton to President Carter (Oct. 7, 1977).

[208] 48 U.S.C. § 1397 (1976); 48 U.S.C. § 1421i(a): (Supp. 1979).

[209] TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 10–13, 34–35. This report showed that, assuming that the nominal earnings of taxpayers kept pace with inflation, the ratio of federal individual income taxes to earned income tended slightly to increase at virtually all income levels between 1973 and 1978, despite the reductions in statutory tax rates. On the conservative assumption that nominal

A 1979 report by the staff of the Virgin Islands Legislature Committee on Finance also discounted the effect of U.S. tax law changes on Virgin Islands tax performance.[212] This study estimated that the actual level of individual income tax collections in 1978 was slightly less than 60 percent of potential revenues, taking into account the growth of Virgin Islands incomes after 1970 and changes in the federal income tax laws. This report, which also studied changes in the level of receipts from local Virgin Islands taxes, concluded that "it appears that a policy has been established to forego enforcement of the Virgin Islands internal revenue laws,[213] and to seek, instead, to subsidize the resulting shortfalls of revenues by incursions into the U.S. Treasury." [214]

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incomes in the Virgin Islands increased at an annual rate two percentage points less than the average U.S. inflation rate, the report found that the average effective tax rate in the Virgin Islands should have dropped by only 8 percent between 1973 and 1978—from 7.2 percent of taxable income to 6.6 percent. The actual collections of individual income taxes in the Virgin Islands fell by 14 percent—from $38 million to less than $33 million between 1973 and 1978—an astounding result in view of the substantial growth in the Virgin Islands economy in this period and rates of inflation in excess of U.S. mainland rates.

[210] *Id.* at 33-34. The average effective tax rates were estimated by weighting the effective U.S. tax rate for each income level and filing status by the percentage of Virgin Islands taxpayers subject to that rate. The income distribution and filing status data were derived from a random sample of 200 individual income tax returns filed with the Virgin Islands for tax year 1977.

[211] *Id.* at 34. The report did not provide direct evidence of deficiencies in tax administration or compliance. Such evidence is provided in Internal Revenue Service, Report on Internal Audit of the Virgin Islands Tax Division (various years). *See also* Report of the Comptroller General of the United States, Government of Guam's Effectiveness in Administering its Territorial Income Tax Laws (1979), and U.S. Dep't of the Interior, Audit Report on the Department of Revenue and Taxation, Government of Guam (1975).

[212] Committee on Finance, Virgin Islands Legislature, A Study of the Collection of Revenues in the Virgin Islands for 1978 (June 1979).

[213] The reference is to the U.S. income tax laws, made applicable to the Virgin Islands pursuant to 48 U.S.C. § 1397 (1921), and to locally enacted Virgin Islands tax laws.

[214] Committee on Finance, Virgin Islands Legislature, *supra* N. 212, at vii.

Alternatives to the Present Federal-Territorial Income Tax Relationship

The mirror system may be described as one income tax law servicing three independent tax jurisdictions. The mirror system operates differently in the Virgin Islands and Guam, but in both cases gives rise to legal confusion and opportunities for federal tax avoidance and evasion, while it places an unreasonable and inappropriate administrative burden on the territories. Two paths to reform are possible. Both approaches assume that the territories, which have no voting representation in Congress, will continue to be exempt from taxation for the support of federal programs.

A Unified Federal-Territorial Income Tax System

The most direct solution, which has been considered in the past,[215] would be to extend the U.S. income tax jurisdiction to include the Virgin Islands and Guam,[216] and to remit all taxes attributable to these territories to the territorial treasuries. All individuals and corporations resident in or deriving income from the Virgin Islands or Guam would be treated in the same way as stateside individuals and corporations. To preserve the federal assistance which the Virgin Islands and Guam currently receive, the Service would remit to each territory (1) the full amount of federal income taxes paid by its end-of-year residents; (2) in the case of nonresident individuals, a prorated amount of federal taxes based on the ratio of territorial source income to worldwide income; and (3) in the case of corporations, a prorated amount of federal taxes based on the ratio of territorial source income to combined territorial and U.S. source income. This formula would provide a division of revenues between the United States and the territories comparable to that under present law.[217]

Extension of U.S. income tax jurisdiction to the territories would be a radical simplification of current law and would resolve all of the ambiguities therein. The amount of federal revenue sharing would be based on apportionment by the Service, rather than on application of the mirror theory to each taxpayer residing in or deriving income from the Virgin Islands, and to each corporation chartered or operating in Guam. Taxpayers would have to file only one income tax return. The only special burden on taxpayers would be the requirement that corporations and certain individuals receiving income from the Virgin Islands or Guam file an information return reporting their income according to source.[218] Territorial residents would not have to file such an information return, except in the unlikely case that a resident of the Virgin Islands (or Guam) received income from Guam (or the Virgin Islands). The territories would be freed from the statutory requirement that they administer the unwieldy and constantly changing U.S. income tax laws, but would continue to receive the revenues collected in the territories under those laws. Administration by the Service should increase territorial tax revenues through improved collection and compliance. In addition, the potential for tax evasion would be reduced by bringing U.S. citizens and corporations under the common tax administration of the Service.

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[215] It was considered by, among others, the 1970 Interagency Committee on the Virgin Islands, the 96th Congress, and the Carter administration.

[216] This could be accomplished by redefining the term "United States" in I.R.C. § 7701(a)(9) to include the Virgin Islands and Guam.

[217] For a detailed comparison of the amount of federal revenue sharing provided by current law and the above formula, see letter from Donald C. Lubick, Assistant Secretary for Tax Policy, U.S. Treasury, to Paul M. Calvo, Governor of Guam (Jan. 7, 1980).

A proposal for a unified federal-territorial income tax was introduced by Senator Bennett Johnston in November 1979.[219] In February 1980, President Carter announced that he supported the proposal to replace the mirror systems with direct extension of the U.S. income tax system, and that he would submit similar legislation.[220] Senator Johnston and the Carter Administration viewed the proposal as a solution to the technical flaws in the mirror systems and as a means to increase the revenues available to the financially pressed territorial governments.[221]

Despite the advantages of this proposal, its drawback is that it represents a change in the long-standing federal policy toward increased autonomy for the territories. The territorial leaders look upon their authority to administer the locally applicable income tax laws as a basic attribute of self-government.[222] The government of Guam viewed the Carter bill as a "tax 'take-over' proposal [which] threatens to gut the very substance of our political life as a self-governing territory."[223] The territories also perceived a conflict between the Service's interest in enforcing the law and their own concern that the territorial share of total revenues be maximized. Such a conflict could arise in the application of residence rules and transfer pricing standards. Territorial opposition to this proposal persuaded the Carter administration to postpone indefinitely the transmittal of its bill to Congress, with the result that the Senate did not take up the issue of the territories' tax status in 1979 or 1980.

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[218] Such a requirement currently applies to certain high-income individuals resident in or deriving income from Guam. I.R.C. § 7654(a). A similar requirement applies as well to individuals and corporations which claim a foreign tax credit. I.R.C. § 904.

[219] S. 2017, 96th Cong., 1st Sess. (1979). That bill applied not only to the Virgin Islands and Guam, but also to the Northern Mariana Islands and American Samoa. The Northern Mariana Islands was included in the proposal because, under 1976 law, all federal tax arrangements for Guam apply equally to the Northern Marianas. See the text accompanying Ns. 228–230 *infra*.

[220] White House Press Release (Feb. 14, 1980). The Carter administration prepared such a bill and circulated it widely in the territories. The bill was never officially transmitted to the Congress, but nonetheless was reflected in the federal budget for fiscal year 1982, submitted in January 1981 by the outgoing Carter administration.

[221] 125 CONG. REC. S16894–16896 (daily ed. Nov. 16, 1979), and White House Press Release (Feb. 14, 1980). See also Letters from G. William Miller, U.S. Secretary of the Treasury, to Juan Luis, Governor of the Virgin Islands, and to Paul M. Calvo, Governor of Guam (both dated Sept. 26, 1980).

Independent Federal and Territorial Income Tax Systems

Rather than solving the problem of meshing the U.S. income tax and the mirror systems by unifying the federal and territorial income tax jurisdictions, the problems of tax harmonization could be resolved by granting the Virgin Islands and Guam autonomy over locally applicable income tax laws. That is, the Virgin Islands and Guam would administer their own territorial income tax imposed under local law, and would be treated for certain purposes under the Code like a foreign country, subject to the safeguards built into the Code to combat tax avoidance and evasion by U.S. taxpayers who reside in or derive income from a foreign country. However, U.S. citizens who were resident in the Virgin Islands or Guam at the end of the tax year would be exempt from U.S. tax on territorial source income. Such an exemption currently applies to full-year residents of Puerto Rico, who can exclude, under section 933, all income derived from sources within Puerto Rico (except amounts received as U.S. government salaries).[224] The United States would prevent double taxation with respect to foreign source income by allowing a dollar-for-dollar foreign tax credit for taxes paid to the Virgin Islands or Guam.

The federal government would provide financial and technical assistance in helping the territories develop alternatives to their present income tax law, in administering whatever laws are in place, and in training local people to administer the tax laws.[225] The territories would be encouraged to design an income tax which was simpler and more broadly based than the Internal Revenue Code, and which was not automatically changed each time Congress amended the federal income tax laws. To reduce the burden of enacting separate definitions of the tax base, the territories might choose, as 21 of the 50 states have, to incorporate the Code's definition of gross income into their own individual and corporate income taxes.[226] To ensure that the Virgin Islands and Guam obtain the same level of federal assistance under this proposal as they receive under current law, federal taxes paid by U.S. citizens resident in the Virgin Islands or Guam would be remitted to the territory.[227] Provision for the transfer to the territory of all U.S. taxes from sources outside the territory also has the advantage that it eliminates the need for the territory to enforce a tax on foreign source income.

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[222] *See, e.g.*, letter to G. William Miller, Secretary of the U.S. Treasury, from Juan Luis, Governor of the Virgin Islands (July 18, 1980).

[223] Letter to Wallace Green, Deputy Under Secretary of the U.S. Interior Department, from Paul M. Calvo, Governor of Guam (Oct. 9, 1980).

[224] See the text accompanying Ns. 44–46 *supra*.

[225] Similar efforts have taken place between the United States and developing

This reform would provide a straightforward system for harmonizing the federal and territorial income tax jurisdictions. U.S. citizens resident in the Virgin Islands or Guam as of the end of their tax year would be subject to federal income tax on their worldwide income with the exception of territorial source income. The territorial income tax would take the place of the U.S. income tax with respect to income derived from the territory by territorial residents. The United States would transfer to the territory any federal income taxes paid by territorial residents. This reform would resolve the technical problems created by the mirror systems, with no loss in territorial autonomy or potential territorial revenues.

Epilogue and Conclusions

A pattern once set is hard to break. Although the federal revenue sharing provisions for the Virgin Islands and Guam are riddled with

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countries. The Service provides technical assistance in tax administration to developing countries through its Tax Advisory Assistance Staff (in general, funded by AID), and also provides assistance in drafting tax laws to a few developing countries on a reimbursable basis. *See* Oldman & Surrey, *Technical Assistance in Taxation in Developing Countries*, MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP 278 (Bird & Head eds. 1972).

[226] NATIONAL GOVERNOR'S ASSOCIATION, INFO LETTER—FEDERAL TAX POLICY: IMPLICATIONS FOR THE STATES 5 (Jan. 15, 1981).

[227] Although federal taxes paid by U.S. citizens resident in Puerto Rico are not remitted to Puerto Rico, it does enjoy primary jurisdiction to tax the income of its residents which is sourced outside the United States. Thus, a resident of Puerto Rico is entitled to claim a foreign tax credit against his U.S. tax liability for Puerto Rican taxes paid with respect to income from sources abroad. Because Puerto Rico's individual tax rates are somewhat higher than those in the United States, the foreign tax credit generally offsets any U.S. liability with respect to that income.

complexities and have not provided the hoped-for territorial financial autonomy, the U.S. tax relationship with the newly acquired territory of the Northern Mariana Islands was set in the same mold.

The Northern Marianas

The Northern Marianas is a group of Pacific islands with a 1980 population of approximately 17,000. After World War II, jurisdiction over the islands was transferred from Japan, under a League of Nations mandate, to the United States, under a trusteeship agreement with the United Nations. In 1976, the Northern Marianas affiliated with the United States as a self-governing commonwealth.[228] The covenant establishing the commonwealth sets out the federal income tax relationship with these islands. Section 601 provides that U.S. citizens [229] resident in the Northern Marianas will satisfy their U.S. income tax obligations by paying the tax due on their worldwide income to the Northern Marianas. The Northern Marianas will administer the U.S. income tax laws as a separate territorial income tax "in the same manner as those laws are administered in Guam." Under section 602 of the covenant, the Marianas can impose additional taxes under local law, and can provide for rebate of taxes received by it on Marianas source income. Section 703 of the covenant, using language identical to that which authorizes the rum fund for Puerto Rico and the Virgin Islands, requires the United States to transfer to the Northern Marianas "the proceeds of all taxes collected under the internal revenue laws of the United States on articles produced in the Northern Mariana Islands and transported to the United States." [230]

Responding to difficulties foreseen in implementing the U.S. income tax laws, the Northern Marianas legislature provided for the 100 percent abatement of the mirror tax on Northern Marianas source income.[231] Congress subsequently declared this to be "contrary to the intent" of the covenant and delayed the effective date of the mirror system (as applicable to Northern Marianas source income) until 1981.[232] Congress also authorized the Internal Revenue Service, upon the request of the Northern Marianas, "to administer and enforce" the mirror income tax in the Northern Marianas free of cost to the territory.[233] Representatives of the Northern Marianas government explored this possibility with the Service in several meetings from 1979 through 1981. The meetings were unproductive because the Northern Marianas and the Service were unable to agree on the sharing of ultimate authority over the administration of the income tax.[234]

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[228] 48 U.S.C. § 1681 note (1976). See N. 16 *supra.*

[229] Sections 301–303 of the Covenant to Establish a Commonwealth of the Northern Mariana Islands grant U.S. citizenship to all persons who are domiciled in the Northern Marianas and who do not owe allegiance to a foreign state, effective with formal termination of the United Nations trusteeship agreement. All persons born in the Northern Marianas after that date will be U.S. citizens at birth.

[230] At present, the Northern Marianas does not export to the United States any goods, such as alcoholic beverages or tobacco products, which are subject to a U.S. manufacturer's excise tax. The Northern Marianas thus does not currently benefit from this provision.

[231] Pub. L. No. 1–30 of the Northern Mariana Islands, ch. 2 §§ 1–5 (1979).

Seeing that no solution had been worked out for the administration of the mirror system, Congress, in December 1980, again extended the effective date of the mirror system as applicable to Northern Marianas source income. The new effective date is January 1983.[235] At present, the operating expenses of the Northern Marianas government are financed by a graduated gross income tax imposed under Northern Marianas law, and by the annual U.S. grant provided under the covenant through 1987.[236]

Practical Problems

Those who have espoused the use of the federal tax system to finance the territories have not thought through the practical problems to which such arrangements give rise. This article has highlighted the problems that have been created by the special federal tax relationship with the Virgin Islands and Guam. Both the grant to the Virgin Islands (and Puerto Rico) of certain federal excise taxes—the so-called rum fund—and the grant of the right to collect federal income tax locally are inherently flawed.

The U.S. Department of the Interior report on the Virgin Islands economy implies that the rum fund is a complex and wasteful system for "the shifting of fiscal levies among consumers, producers, the Federal Government and the Virgin Islands Government." [237] Consumers pay a high duty on foreign rum in order to protect the Virgin Islands (and Puerto Rican) rum producer, and also pay the federal excise tax applicable to all alcoholic beverages. The excise tax on rum produced in the Virgin Islands or Puerto Rico is transferred from the U.S. Treasury to the territories, which in turn subsidize the local rum industries. The Interior Department report states:

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[232] Pub. L. No. 96-205, § 205(a), 205(c), 94 Stat. 87 (1980).

[233] Pub. L. No. 95-348, § 3(d), 92 Stat. 489 (48 U.S.C. § 1681 note (Supp. 1979)), *amended by* Pub. L. No. 96-205, § 204, 94 Stat. 86 (1980).

[234] See letter from Jerome Kurtz, Commissioner of Internal Revenue, to Carlos Camacho, Governor of the Northern Mariana Islands (Sept. 24, 1979).

[235] Pub. L. No. 96-597, § 303, 94 Stat. 3478 (1980).

[236] Pub. L. No. 94-241, § 704, 90 Stat. 273 (48 U.S.C. § 1681 note (1976)).

[237] THE ECONOMY OF THE U.S. VIRGIN ISLANDS, *supra* N. 127. *See also* the text accompanying Ns. 117-32 *supra*.

> Thus the U.S. consumer and the U.S. Treasury subsidize the Virgin Islands producer and the Virgin Islands treasury. The original object of [the V.I. rum fund] was to encourage local Virgin Islands tax collections by matching them with a transfer payment from the U.S. Government. The payment from the U.S. Government continues, while the incentive no longer applies to the collection of local taxes but to the production of rum.[238]

Mirror Systems

The principal means by which U.S. tax dollars are channelled to the Virgin Islands and Guam are the so-called mirror systems. The mirror systems, as applicable to individual and corporate income taxes in the Virgin Islands and to corporate taxes alone in Guam, involve a transformation of all Internal Revenue Code provisions which make a distinction between foreign source and domestic source income and between foreign and domestic persons. Since taxation of international transactions involves some of the most complex provisions of the Code, the mirror systems are peculiarly susceptible to technical problems. Especially in the Virgin Islands, the mirror system gives rise to difficult problems of interpretation, harsh tax results for some taxpayers and loopholes for other taxpayers. Application of the mirror system to individuals resident in or deriving income from Guam was simplified in 1972. The new scheme, under sections 935 and 7654 of the Code, eliminates the discriminatory treatment of U.S. citizens as foreign persons under the Guam mirror system. However, the new scheme gives rise to inconsistencies between federal laws regarding liability for tax and federal tax withholding obligations.[239]

The purpose of the special federal tax relationship with the Virgin Islands and Guam is to provide these territories an independent source of revenue, and thereby promote their fiscal autonomy.[240] The 1979 Treasury Report noted that: "The most obvious disappointment [with respect to the Virgin Islands and Guam mirror systems] has been in the amount of income tax revenues collected by the territories." [241] Tax collections under the mirror systems were stagnant in the 1970's: as a percentage of gross territorial product, they fell by roughly one third. Substantial evidence exists that a major cause of the decline in tax effort was decreasing tax enforcement and compliance in the territories. Nonetheless, reductions in U.S. income tax rates in the 1970's furnished an argument for providing increased federal appropriations to the territories.[242] Rather than promoting the fiscal autonomy of the territories, linkage between the territorial tax systems and U.S. income tax laws has blurred the responsibility of the Virgin Islands and Guam to assume the burden of fiscal solvency.

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[238] *Id.* at 25.

[239] See the text accompanying Ns. 168–72 *supra.*

[240] See the text beginning at Ns. 51 & 144 *supra;* Rev. Rul. 78-327, 1978-2 C.B. 196; Dudley v. Comm'r, 258 F.2d 182 (3d Cir. 1958); S. 2017, 96th Cong., 1st Sess. (1979).

[241] TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 2.

Two Possible Approaches

This article outlines two possible approaches to the reform of the federal tax relationship with the Virgin Islands and Guam. The first would extend the U.S. income tax system directly to those territories. All revenues attributable to a territory would be remitted to the territory. The second would make the Virgin Islands and Guam autonomous for purposes of taxation. The United States would exempt from tax the territorial source income of territorial residents, as the Code presently provides for Puerto Rican residents under section 933. Territorial residents would thus be subject to federal tax only on U.S. source income and income sourced in foreign countries. The proceeds of the federal tax on the residents of a territory would be remitted to the territory.

Either of these reforms would end the legal disarray and potential for U.S. tax avoidance and evasion under the present mirror tax systems. The choice involves a trade-off between federal assumption of responsibility for territorial revenues, on the one hand, and territorial autonomy, on the other. The first approach retains the linkage between income tax rates for federal taxpayers and territorial taxpayers. As a result of administration by the Service, this approach would probably result in a substantial increase in territorial revenues. The second approach reflects the U.S. commitment to the fiscal autonomy of the Virgin Islands and Guam. These territories would have authority to develop a tax system suited to their needs and administrative resources, and they would be free to work out their own balance between income tax burdens and local government spending.

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[242] The most recent occasion for a request for a federal appropriation to offset reductions in territorial revenues resulting from a federal tax law change occurred in connection with President Reagan's proposal for a 30 percent tax cut. The request was made on May 21, 1981 in a statement by Rep. de Lugo before the Senate Finance Committee concerning the impact of the Reagan administration's tax proposals on Virgin Islands. See also Res. 15, 16th Guam Legislature (1981) (expressing support for the proposed tax reduction and petitioning the United States to compensate Guam for the loss in territorial revenues). To meet these requests, S.1674, 97th Cong., 1st Sess. § 204 (1981) would authorize appropriations to the Virgin Islands, Guam and American Samoa to offset "any revenue reductions they sustain as a result of the enactment of *any* general federal tax revision or reduction" (emphasis added).

Western Governors' Association Resolution 85-010

August 28, 1985
Honolulu, Hawaii

SPONSOR: Governor Bordallo
SUBJECT: Tax Policy for Guam and Confederation of Northern Mariana Islands (CNMI)

A. BACKGROUND

1. Federal statutes currently require that the income tax of the government of Guam mirror the federal income tax laws.

2. Numerous tax reform proposals are currently before Congress. The tax reform bill proposed by President Reagan would not be revenue neutral with respect to Guam. It is estimated that the proposal would cost the government of Guam more than $18 million in lost local revenue during FY 1986.

3. Under the Administration's proposed plan, Guam would lose $4 million in FY 1986 due to reduced revenues pursuant to Section 30 of the Organic Act of Guam. Further, recent federal tax changes (e.g., the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982) already have cost the government of Guam approximately $27 million over the past three years.

4. The federal government has not compensated Guam for this lost revenue, despite a long-standing federal policy to reimburse Guam for losses caused by federal tax reforms.

B. GOVERNORS' POLICY STATEMENT

1. The western governors urge Congress not to adopt a tax reform proposal which would result in revenue losses for Guam and CNMI.

2. The western governors also urge Congress to "de-link" the federal income tax system for Guam and CNMI and allow Guam and CNMI to establish an independent tax system.

C. GOVERNORS' MANAGEMENT DIRECTIVE

1. Convey the Western Governors' Association position to the appropriate members of Congress and the Administration.

DISPOSITION:

Approved: Ariyoshi (HI), Sinner (ND), Bangerter (UT), Bordallo (Guam), Tenorio (NMI), Gardner (WA), Lutali (A.S.), Schwinden (MT), Atiyeh (OR), Evans (ID), Anaya (NM).

Disapproved: ____

Abstained: ____

Not Present: Sheffield (AK), Babbitt (AZ), Deukmejian (CA), Lamm (CO), Kerrey (NE), Bryan (NV), Janklow (SD), Herschler (WY).

The CHAIRMAN. Mr. Nordberg.

STATEMENT OF CARL A. NORDBERG, JR., EXECUTIVE DIRECTOR, PUERTO RICO U.S.A. FOUNDATION, WASHINGTON, DC

Mr. NORDBERG. Thank you, Mr. Chairman.

My name is Carl Nordberg. I appear here today in my capacity as the executive director of the Puerto Rico U.S.A. Foundation. With me is Mr. Salvador Casellas, who is counsel to the foundation; and Mr. John Beyer, who is president of Robert R. Nathan Associates, who are our economic consultants.

One of the benefits or detriments of being the last witness on an issue is that most of the issues that I would have liked to cover have been covered very well, and I'm not going to take this committee's time and repeat them.

I would just like to briefly state several points. In the first place, the Treasury Department proposed this alternative wage credit because they contended that 936 has not created jobs in Puerto Rico. I think the discussion that has been held here this morning clearly indicates that 936 has created substantial employment in terms of Puerto Rico; not only in terms of numbers, but also in the quality of the jobs that the 936 companies have produced for Puerto Rico.

Second, as far as the wage credit is concerned—I would like to refer to the chart that we have here. You will see the problem that the wage credit creates for Puerto Rico. Even with the wage credit, which is at the bottom of the chart, a $3.12 wage in Puerto Rico is just not competitive—as Senator Long pointed out earlier this morning—with the wage rates in the other areas of the Caribbean and throughout the world. So in trying to compete for goods that are produced by low-cost labor, we feel very strongly that a wage credit of this type is just not going to be sufficient to eliminate the competitive disadvantage.

In fact, Senator Long, we really feel that any kind of a wage credit approach is not going to work because Puerto Rico's economy with respect to exported products has really advanced beyond the point where they are competitive. But with respect to what you were discussing earlier, maybe if the focus could be on products and services that were consumed on the island, then a wage credit might be a help to Puerto Rico's situation as far as the 22-percent unemployment is concerned.

The Governor commented on the revenue estimate that was prepared by the Treasury Department. Every nongovernmental economist that has locked at it thinks it is far overstated. One of the primary mistakes the Treasury Department has made is that they have assumed that the companies will not react to a change in the law vis-a-vis 936. All of us here know that the companies will react. They will react in a fashion to minimize their taxes and maximize their profits.

It's unfortunate Senator Mitchell has left because we have just concluded a study which clearly reflects that the companies will leave Puerto Rico if 936 is repealed, and most of the companies will not be coming back to the United States, assuming the foreign tax provisions and other areas of the code remain as they are.

Another point that no one else had made but I would like to emphasize—we also have in this area a question of competitiveness. We all know that the U.S. electronic and computer firms are at this point in time locked in a competitive battle particularly with the Japanese companies. Section 936 is one of the economic tools that our electronic and computer firms are using. There are a number of such firms located in Puerto Rico with significant operations there that are expanding.

I would point out that while our Treasury Department proposes to strip this economic tool from our electronic and computer firms, the Japanese Government has negotiated tax treaties with the various developing and tax-haven countries in the world that provide Japanese firms with precisely the same type of tax treatment that our companies now get through 936. I don't think we should be stripping this tool from our companies while the Japanese are out giving exactly the same tool to their companies.

Mr. Chairman, I'm going to be one of the few that is going to stop early in an effort to curry the favor of the committee. [Laughter.]

The CHAIRMAN. You would be amazed at what works. [Laughter.]

Mr. NORDBERG. I thought I'd try it.

[The prepared written statement of Mr. Nordberg follows:]

PUERTO RICO U. S. A. FOUNDATION

Testimony of

Puerto Rico U.S.A. Foundation
by Carl A. Nordberg, Jr., Executive Director

Before

Committee on Finance
United States Senate

Regarding

Administration's Proposal to Repeal
Section 936 and Substitute a Partial Wage Credit

October 3, 1985

Good morning - My name is Carl Nordberg. I appear today in my capacity as Executive Director of the Puerto Rico U.S.A. Foundation. Attached to my testimony is a list of the 75 members of the Foundation. As the list reflects, our members range in size from Puerto Rico's largest employers to the smallest and these companies are involved in the manufacture of electrical equipment, electronics and other high technology products, pharmaceuticals, chemicals, medical davices, apparel, food as well as financial activities. Our companies employ more than 2.5 million persons on the U.S. mainland. Our Puerto Rican employment is approximately 80% of the direct section 936 employees.

In the time available to me I would like to make just five points:

First, the Treasury Department contends that Section 936 has not created additional employment in Puerto Rico. It is wrong! Section 936 companies have created tens of thousands of new jobs -- and they are skilled, high-paying jobs which have done much for the Puerto Rican economy and quality of life of its people. In a word, Section 936 works!

Second, the wage credit proposed by the Administration as a substitute for section 936, will not be an effective incentive to attract labor intensive industries to Puerto Rico. This conclusion applies to any wage credit likely to be seriously considered.

Third, in the discussion of its proposal to repeal Section 936, the Treasury admits that the repeal of section 936 will cause the high tech and other operations employing skilled people to leave Puerto Rico. But, many other types of operations, including the major employers will also leave the island. A recently completed study by Robert Nathan Associates concludes that the Treasury proposal will create levels of unemployment in Puerto Rico, within five years, of 30 percent, and within 15 years, of 36 percent.

Fourth, in our judgment it is unwise to strip our high technology firms of the benefits of section 936 in the midst of their struggle to retain their international competitiveness. It is significant that the government of Japan has concluded a number of tax treaties with tax haven countries which grant section 936 type treatment to its own high technology firms.

Fifth, the Treasury has vastly overestimated the revenue costs relating to section 936. The actual revenue cost per job is approximately the cost of maintaining an unemployed worker.

I will now elaborate on each of the five points.

Treasury's contention that Section 936 has not created additional employment in Puerto Rico is just wrong. Tens of thousands of skilled, high-paying jobs have been created by Section 936 companies. For example, in the period 1974-82, total manufacturing employment in Puerto Rico declined from 141,000 jobs to 134,000 jobs. However, in the same period, employment by 936 companies increased from 63,000 jobs to 82,000 jobs. Moreover, the quality of jobs provided by 936 manufacturers by far exceeds that of jobs in manufacturing in general. Average wages in high-tech industries where 936 companies predominate are considerably greater than in labor-intensive industries.

We are confident that a wage credit will be ineffective in attracting labor intensive industries to locate in Puerto Rico. The island's economy is well beyond the point where its competitive advantage in world markets lies in labor intensive activities using low cost labor.

Puerto Rico's economy has progressed from the 1950's when nearly 83 percent of workers were employed in manufacturing of textiles, apparel, tobacco, food and related products. Employment in those industries has fallen dramatically while employment in the high tech industries has risen dramatically. For example, during the period 1968-1984 combined employment in the high tech industries rose by 247 percent. In 1984, high tech industries accounted for more than 40 percent of Puerto Rico manufacturing employment.

The salient fact is that wages in Puerto Rico, even with a wage credit, would remain significantly above those of other countries where goods for sale in world markets are produced using labor intensive processes.

Please refer to Table I. There you see the comparisons - a wage cost of $3.12 per hour is no bargain when you can get the same job done for $.33 or $1.43. Employers are not going to take labor intensive operations to Puerto Rico where they will incur a labor cost of 2 or 3 times what would be incurred elsewhere.

The Treasury's wage credit proposal is designed to return Puerto Rico's economy to the days of sugar cane, cigar wrapping and sewing. We are confident that the proposal will not work....but even if it did, imagine how the quality of life would deteriorate in Puerto Rico.

This brings me to my next point. What will happen to the operations that are currently being conducted in Puerto Rico. The Treasury admits in last November's Tax Reform Report to the President that repeal of section 936 will cause the high tech firms to leave. These firms employ 40% of the island's manufacturing employees. They employ skilled people and they pay very substantial salaries. we have just concluded an economic study which appraises the full damage of a 936 repeal -- damage that goes well beyond Treasury's admission. Clearly, the magnitude of the adverse impact would be very substantial.

(1) Substituting a wage credit for Section 936 will create levels of unemployment in Puerto Rico as high as 36 percent; stifle the development of the economy of Puerto Rico; reduce Puerto Rican per capita income; and cause a substantial negative fiscal impact on the Puerto Rican Treasury under conditions where the demand for services and payments from the public sector will greatly intensify.

(2) Moreover, the economy of Puerto Rico will suffer under a wage credit compared with Section 936 because investment would virtually halt with the withdrawal of the incentives offered by the income based tax credit. Moreover, many existing 936 operations, particularly those with the largest employment, will leave Puerto Rico as soon as the operation ceases to be competitive with alternative operations. These terminations will commence as soon as their Puerto Rican grants expire but no later than in four or five years.

Table II shows that, in most instances, the Treasury proposal will drive the operations currently located in Puerto Rico to foreign locations.

My next point relates to international competitiveness. It is no secret that the U.S. high tech semiconductor and computer firms are locked in competitive struggle with their Japanese counterparts. We would all like to see this struggle concluded with the U.S. companies emerging as the victors. One of the economic tools of the U.S. companies is the tax benefit of section 936. The Treasury would strip this tool from the U.S. companies. It is important that the Congress be aware that while the Treasury proposes to strip this tool from U.S. companies the Japanese government has negotiated tax treaties with a number of tax haven countries so as to provide section 936 type treatment to their high tech firms. These countries include South Korea, Singapore, Ireland and Malaysia. In this struggle for competitiveness, we may not be able to match some of the benefits foreign governments provide, but we should extend reasonable assistance where possible and that includes continuing section 936.

My final point addresses the revenue cost of 936. In estimating the revenue cost of section 936, Treasury makes two critical and erroneous assumptions. First, Treasury assumes that companies will not react to the repeal of section 936 in ways designed to protect their profitability and minimize their tax exposure. Second, Treasury assumes Puerto Rico won't take the logical step of exercising its right of primary tax jurisdiction. Clearly the companies and Puerto Rico will react and the aggregate effect of those reactions will be that any revenue gain to the U.S. Treasury will be minimal.

However, even if one embraces Treasury's "static measure" of tax cost, the Treasury estimate still suffers from two basic flaws. First, the Treasury only takes into account for direct employment generated through 936. The appropriate measure of tax cost per job is the total employment attributable to section 936 -- the indirect as well as the direct employment.

Second, since the goal is to evaluate the future cost of section 936, that future impact should be determined by application of the Treasury's proposed reduction in the corporate tax from 46 to 33 percent.

Attached Table III makes these two corrections to the Treasury's numbers and shows the tax cost per job is $5,660 rather than the $20,663 alleged by Treasury.

Summary

In summary, section 936 has been successful and efficient. Its critics have puffed its costs far beyond reality and offered an alternative that is well meaning but ill-conceived and ineffective. We urge the Congress to preserve section 936 so as to continue the economic development of the island and the improvement in the quality of life for its three million U.S. citizens.

TABLE I

Table IV-1. Comparisons of Hourly Wages Puerto Rico vs. Other Exporters of Selected Labor Intensive Goods, 1982 (U.S. dollars)

Country	All manufacturing	Apparel and textile	Leather footwear
Caribbean Basin			
Jamaica[a]	1.38-3.50		
Brazil[b]	1.98		
Mexico[b]	1.43		
Dominican Republic[c]	.72		
Haiti[d]	.33		
Far East[b]			
Hong Kong	1.37	1.30	1.62
Taiwan	1.33	1.21	1.23[e]
Korea	1.04	.67	.75
Puerto Rico			
No wage credit[f]	4.64	3.78	3.80[e]
Wage credit[g]	3.12	2.38	2.39

a. Unskilled workers average $55 per week. Skilled workers average from $100 to $180 per week. Jamaica Business Fact Sheet, Caribbean Basin Initiative, U.S. Department of Commerce, and Caribbean Business, February 29, 1984.

b. Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, unpublished data, "Hourly Compensation Costs for Production Workers in Manufacturing Industries, 36 Manufacturing Industries, 29 Countries", April 1984.

c. Legal monthly minimum divided by average of 173.3 hours worked per month. Caribbean Business, February 29, 1984.

d. Minimum wage is $2.65 per day. Haiti Business Fact Sheet, Caribbean Basin Initiative, U.S. Department of Commerce.

e. Data for leather and leather products, SIC 31.

f. Source: U.S. Department of Labor, Bureau of Labor Statistics.

g. Wage credit figures reflect the net benefit of the wage credit by taking into account the value of the tax credit [(.6 x min. wage) + .2 (wage - min. wage)] less the loss of the tax deduction on that amount of the wage counted in the tax credit, assuming a marginal tax rate of 33 percent.

TABLE II

Impact of a Wage Credit on Relative Profitability of Being a Possessions Corporation for Growth Industries

Industry	Puerto Rico reincorporation	Relocation	
		U.S.	Foreign
	percent		
Food	3	-24	17
Instruments	5	-16	15
Electrical machinery	5	-17	14
Machinery/computers	6	-17	15
Chemicals/pharmaceuticals	10	-4	13

Impact of a Wage Credit on Relative Profitability of Being a Possessions Corporation for Declining Industries

Industry	Puerto Rico reincorporation	Relocation	
		U.S.	Foreign
	percent		
Textiles	-26	-58	12
Apparel	-18	-44	9
Leather	-17	-45	8
Rubber	-8	-32	19
Fabricated metals	5	-17	13

Source: RRNA

TABLE III

Treasury and RRNA Estimates of 936 Tax Benefits per Job, 1982

1.	Treasury estimate		
a.	Total estimated tax benefits, all 936 manufacturing corporations, 1982 (million dollars)	1,679	
b.	Estimated direct 936 employment, 1982	81,257	
c.	Estimated tax benefit per job (dollars)		20,663
2.	RRNA estimate		
a.	Adjustment to reflect impact of TEFRA[a] (million dollars)	1,470	
b.	Treasury estimate adjusted to reflect 33 percent corporate tax rate (million dollars)	1,050	
c.	Total 1982 936 employment (direct and indirect)	186,000	
d.	Estimated tax benefit per job (dollars)		5,660

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[a] While little empirical evidence exists concerning the impact of TEFRA on Treasury receipts, a RRNA survey of 936 firms indicated an overall reduction in tax benefits of about 13 percent. While the magnitude of the reduction varied significantly among firms, it is a reasonable benchmark for estimation purposes here.

Source: RRNA.

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American Cyanamid Company
American Home Products
American Hospital Supply Corporation
Arthur Andersen & Co.
Avon Products, Inc.
Banco Popular de Puerto Rico
Baxter Travenol Laboratories, Inc.
Bristol-Myers Company
C. R. Bard, Inc.
Carter-Wallace, Inc.
The Chase Manhattan Bank, N.A.
Chesebrough-Pond's Inc.
Citibank, N.A.
The Coca-Cola Company
Colorcon, Inc.
ConAgra, Inc.
Cooper Laboratories, Inc.
Crowley Maritime Corp.
Deloitte, Haskins + Sells
Digital Equipment Corporation
Drexel Burnham Lambert, Inc.
DSC Communications Corporation
Economics Laboratory Inc.
E. I. duPont deNemours & Co.
Eli Lilly and Company
Fluor Corporation/Daniel Construction Company
General Electric Company
Gould, Inc.
The Grow Group, Inc.
Hewlett-Packard Co.
Inland Container Corporation
Intel Corporation
International Playtex Inc.
Johnson & Johnson
Lenox Inc.
Loctite Corporation
Martinez, Odell, Calabria & Sierra
McConnel Valdes Kelly Sifre Griggs & Ruiz-Suria
Medtronic, Inc.
The Mentholatum Co., Inc.
Merck & Company, Inc.
Millipore Corporation
Motorola, Inc.
Nabisco Brands Inc.
O'Neill & Borges
Pall Corporation
Paradyne Corporation
Pelton Company
Pepsico, Inc.
Pfizer, Inc.
Phillips Petroleum Company
Pittway Corporation
Price Waterhouse
Production Graphics Corp.
Prudential-Bache, Puerto Rico, Inc.
Revlon
R. J. Reynolds Tobacco International
Richardson-Vicks Inc.
Roche Products Inc.
Schering-Plough Corporation
Sea-Land Corporation
G. D. Searle & Co.
SmithKline Beckman Corporation
Squibb Corporation
Sterling Drug Inc.
Sun Refining & Marketing Co.
Superba Inc.
Syntex Corporation
United States Surgical Corp.
Upjohn Company
Wang Laboratories, Inc.
Warner Lambert
The West Company
Westinghouse Electric Corporation

The CHAIRMAN. Senator Hernandez-Agosto, let me ask you about the twin-plant concept. How you are going to finance Puerto Rico's part of that, and whether or not this isn't almost going to look like sort of a Puerto Rican colonialism where you are going to keep the high-technology, capital-intensive plants. And as best I can see, sort of farm out to Jamaica and the others the low-wage plants that somehow are going to be intertwined in this twin-plant venture.

Senator HERNANDEZ-AGOSTO. Well, you have to start, Senator, somehow and somewhere. We cannot change the economics of the neighboring islands and countries. So, they pay low wages. Those parts of the operation that require low wages would be manufactured in those countries. But at the same time, in doing so, we will be helping these countries to develop their infrastructure which, facilitating that, in due time they will also achieve the levels of wages that we have achieved. You have to start somewhere. We went through that experience. So, initially, we didn't have the wages we have now. So it is a matter of getting started.

At present the situation is such that they don't get neither one nor the other. They will be getting some; we will be getting some. It will be to our mutual advantage.

The CHAIRMAN. Let me ask you about the President's wage-credit scheme. Are you convinced that his wage-credit scheme, as opposed to 936, would not even produce more jobs?

Senator HERNANDEZ-AGOSTO. Absolutely not.

The CHAIRMAN. Would not?

Senator HERNANDEZ-AGOSTO. Absolutely convinced. It will make us lose a lot of jobs. Absolutely.

The CHAIRMAN. Tell me again why.

Senator HERNANDEZ-AGOSTO. Because when you reach these high-technology industries, then the wage credit is so low that it would be no incentive. For example, you have the chemicals. The average wage paid by chemicals is 60 percent more than the average industrial wage in Puerto Rico; when you reach that point, this wage credit doesn't operate at all.

The CHAIRMAN. And you would not attract other businesses that are labor-intensive that would provide more employment?

Senator HERNANDEZ-AGOSTO. Now we may be able to, with the wage credit, to keep some of our apparel industry; probably shoes and apparel. But it is difficult to think of attracting more industries in that direction. We may be able to keep them.

The CHAIRMAN. Senator Long.

Senator LONG. I'd like to ask one question of Mr. Nordberg. Mr. Nordberg, if we could use some of that food stamp money to subsidize employment, why couldn't Puerto Rico produce its own requirements of tropical fruits?

Mr. NORDBERG. It would seem to me that is something they should consider. Yes; for their own on-island consumption.

Senator LONG. If you don't watch out, you make it so attractive for people to subsist on the welfare benefits that it is difficult to get them to return to work. When you offer them a job a person says, well, why should I do that; I can do almost as well by drawing welfare payments which I lose when I go to work. And work can be a bother. A real pain in the neck. Why do all that when I can sit here and live rather comfortably just drawing for food stamps and the rest.

My thought is that if you could provide employment opportunities, even if you have to subsidize them. I discussed it with Governor Colon. For example, take some of that money and subsidize wages so that you can afford to put people to work harvesting tropical fruits. The fruits will grow; you just need somebody go pick them off the trees.

I can't see much point in having to produce bananas somewhere else and haul them into Puerto Rico. You ought to be able to produce your own requirements in Puerto Rico.

Mr. **Nordberg**. I think you are probably right, Senator.

Senator **Long**. If it's subsidized, that is.

Mr. **Nordberg**. It's been the experience of the companies in our foundation that when you provide the Puerto Rican people an opportunity to work, they will do a great job for you. They are anxious to be able to have a job and to make a contribution to the economic well-being of the island. And I think anything we can find to help with the unemployment problem is going to be very beneficial.

Senator **Long**. Thank you very much.

Senator **Hernandez-Agosto**. Senator Long, Mr. Chairman, may I make a comment in relation to your question?

Senator **Long**. Yes, sir.

Senator **Hernandez-Agosto**. It is this: What you are pointing out brings out another thing, which in my opinion you should know. All these programs are good for the States, and they have their benefits. But in applying them to Puerto Rico, we should have the flexibility from the very beginning to apply these programs to an economy which is different from your economy. We are at a different level of development, and we should take that into consideration. Rather than extending the programs under the same terms that you apply to States, let us apply them on local terms that will be more effective. But we must start that from the very beginning.

Senator **Long**. I thoroughly agree with you, but if bureaucrats in Washington insist on seeing just how you are going to do something, then I want your cooperation, Mr. Hernandez-Agosto, and the Governor's cooperation. If they want to see how you propose to do something, spell it out for them. Say here is what we think we could do and here is how we think we could improve the lives of these people.

I am satisfied that the average family working to make money will be a lot better off than people who become accustomed to surviving on welfare payments.

I was born and reared in a working man's neighborhood. There was a lot of poverty there. But most of us felt that we were going to go somewhere because we were willing to work and we were brought up with the work ethic, as were our parents and grandparents. They all believed that if you worked hard enough, you will get somewhere. And most of the people did.

We want to move the Nation. I think you might help provide an example for the rest of the country by showing that instead of paying money which makes work less attractive, you could pay it to make work more attractive.

Senator HERNANDEZ-AGOSTO. We can come up with some proposals to use money for subsidies for agricultural production. We have been working at that, as a matter of fact.

Senator LONG. I wish they would give Louisiana the same opportunity, but it's better to start somewhere. Thank you very much. [Laughter.]

The CHAIRMAN. Louisiana has had you, Senator Long.

Senator LONG. Yes, but we still have Federal regulations to contend with.

Senator BRADLEY. Mr. Chairman.

The CHAIRMAN. Yes.

Senator BRADLEY. May I submit some questions to the record?

The CHAIRMAN. Absolutely. Thank you.

Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Mr. Hernandez-Agosto, I am appalled by the difference in the figures which the Treasury staff has presented us with the figures you have presented us as to the consequences of the repeal of section 936 tax credit. You say in your statement that rather than 81,250 jobs cited by Treasury staff, over one-quarter million jobs are at stake. Now in making its estimate, did the Treasury in any way consult with you?

Senator HERNANDEZ-AGOSTO. Not at all.

Senator MATSUNAGA. Not at all?

Senator HERNANDEZ-AGOSTO. Not at all. And let me tell you, Senator, these figures are accurate figures. We have taken into consideration the direct jobs, indirect jobs, and through econometric models, we have calculated the impact that these operations in Puerto Rico have in the U.S. economy. And it adds up to the amount we have given you.

Mr. NORDBERG. Senator, if I may just add a point.

Senator MATSUNAGA. Yes, Mr. Nordberg.

Mr. NORDBERG. The difference here is that the Treasury Department refuses to take into account anything beyond a direct employee. They don't count the indirect employees at all as being created by the 936 operation. It's 81,000 direct jobs. Obviously, there are at least 100,000 additional jobs. We have done very thoughtful and complete economic studies which show that the Puerto Rican government's numbers are absolutely correct.

Senator MATSUNAGA. Your unemployment rate today, you say, is 22 percent.

Mr. NORDBERG. That is correct, Senator.

Senator MATSUNAGA. Prior to the enactment of section 936, what was the unemployment rate?

Senator HERNANDEZ-AGOSTO. Well, it has been close to that figure. It came up to 26 percent during the petroleum crisis. It has come down somewhat. But had it not been for 936, I'm pretty sure it would now be 30 or 40 percent. You cannot measure the impact of 936 operations in Puerto Rico just by whether you have had a dramatic reduction in unemployment or not. But you have been able to arrest the trend toward higher unemployment. And with the measures we have been taking, the strict regulations that we have adopted in relation to the use of 936 funds, and other local regulations that we have approved, which we mentioned earlier, we are creating the climate for further economic development. That is what we want to pursue with the least interruptions.

Senator **Matsunaga**. Now, Mr. Nordberg, you state that the Treasury has vastly overestimated the revenue costs relating to section 936. The actual revenue cost per job is approximately the cost of maintaining an unemployed worker. Now what might those figures be?

Mr. **Nordberg**. Our number is something in the range of $5,500.

Senator **Matsunaga**. For both maintaining an unemployed and——

Mr. **Nordberg**. And for the cost, revenue cost, on a per-cost basis. We think 936 is in the range of $5,500.

Senator **Matsunaga**. I see. How did you arrive at those figures?

Mr. **Nordberg**. We took the Treasury Department's numbers, we used their concept, which is a static concept, and assumed that the companies are not going to adjust or react one way or another if section 936 is modified or repealed. Then we made adjustments in three areas. We adjusted for the change that Congress made in the 1982 legislation; we thought that was fair. We adjusted for the indirect as well as the direct jobs; we think that's fair. And since the Treasury Department is looking to the future costs, we adjusted to the corporate rate that they are proposing in their tax reform proposal—33 percent. And when you make those three adjustments and use the rest of their concept, you get a $5,500 number.

Senator **Matsunaga**. Mr. Santos, I'm glad to have heard you mention that you represent as the director of the the Department of Revenue and Taxation the Territory of Guam, United States of America, because too often we forget that Guam is part of the United States of America, as witness the textile bill where you are classified as a foreign country. So you keep reminding Members of the Congress that Guam is United States of America.

Mr. **Santos**. Where America's day begins.

Senator **Matsunaga**. I might just make this one statement that I think your testimony indicates positively that delinkage is the best thing for Guam, and you can be assured of my support.

The **Chairman**. Gentlemen, thank you very much. We appreciate it.

Now if we might have Mr. Al Noftz; Mr. George Lawrence; Mr. Raymond Smith; Mr. Howard Doerr; Mr. Michael Foley; and Mr. Richard Morgan.

Do we have the rest of our witnesses here?

[No response.]

The **Chairman**. We will wait just a moment until they clear out the door and close the door and then we will start.

All right, gentlemen, we will start. And if the others come, we will put them on after you. We will start with Mr. Lawrence, then Mr. Smith, and then Mr. Doerr. I might indicate that in a few moments I have to leave and go to the Senate floor. We are going to start the debt ceiling increase bill, and I've got to handle it on the floor so I won't be able to stay for the entire panel.

Mr. Lawrence.

STATEMENT OF GEORGE H. LAWRENCE, PRESIDENT, AMERICAN GAS ASSOCIATION, ARLINGTON, VA

Mr. LAWRENCE. Mr. Chairman, I represent the American Gas Association. We support the general concept of tax reform. And to accomplish that, we believe that Treasury II is far preferable to the recent Ways and Means proposal.

I'd like to focus today on three areas that are important to our industry—capital cost recovery, appropriate transitional rules, and assuring a plentiful supply of natural gas for the future.

First, the current method of recovering capital costs, combining ACRS depreciation and the investment tax credit, we can support. We can also support the alternative system in Treasury II which would allow most gas distribution and pipeline property to be depreciated over 10 years. What we cannot support is a system in the House Ways and Means draft proposal released last week. That would require most pipeline property to be depreciated over 18 years rather than the 10 years in current law or under Treasury II. Even worse, distribution company assets depreciable over 15 years under ACRS or 10 years under Treasury II would be depreciated under the House draft proposal over 30 years, via straight line.

This would not only impair incentives for investments, but it would also place gas distribution companies at a severe competitive disadvantage because electric utilities could depreciate over 18 years by use of an accelerated recovery method. This is not the proverbial level playing field. And that is needed due to the ongoing and increasing competition between gas distribution and electric utilities for more economic service to customers. This competition benefits both the Nation's economy and consumers of energy.

We also could not support any proposal that eliminates the historic practice of requiring normalization for the recovery of capital costs. Without normalization, a regulated company's customers on the system in the years when taxes are deferred could realize all the benefits of the deferred taxes while later customers would realize none.

Second, AGA believes that the transition rules in both Treasury II and the Ways and Means proposal are inadequate with respect to the investment tax credit for property that is under development, but not yet placed in service. Transition rules should allow the continuation of ITC, provided that binding contracts are in place, application for regulatory approval has been made, or substantial construction has started.

The third point is that we believe that sound Federal policy should encourage the development of our domestic energy resource base. And we believe that to be especially true for our huge natural gas supply potential.

The Treasury II proposal took an important step in that direction by continuing current tax treatment for intangible drilling costs. In contrast, the Ways and Means proposal would impair the development of additional reserves by recharacterizing intangibles as taxable income once a well begins to produce. This would require IDC's for producing wells to be amortized over a 3-year period, which would be a blow to the cash-flow of energy producers.

It's a clear disincentive toward development of producing properties and amounts to a penalty for successful drilling.

Instead of the Ways and Means plan, we believe Treasury II provides the wiser policy with respect to the energy security of the Nation, and especially to the growing contribution that U.S. natural gas can make to our Nation's economic and environmental policies.

In conclusion, AGA supports tax reform efforts. Those are not just nice words for this committee or for the President. Dean Witter estimates that the effective tax rate of the natural gas industry in 1984 was about 44 percent, far above the 16 percent for general industry cited by the Joint Tax Committee. We believe the Treasury II would make significant strides to correct this inequitable distribution of tax burdens. We look forward to working with the committee in its efforts to develop an equitable tax reform proposal.

Thank you.

Senator SYMMS. Thank you very much, Mr. Lawrence.

[The prepared statement of Mr. Lawrence follows:]

STATEMENT OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
FINANCE COMMITTEE
UNITED STATES SENATE
ON THE PRESIDENT'S PROPOSALS TO THE CONGRESS
FOR FAIRNESS, GROWTH AND SIMPLICITY

OCTOBER 3, 1985

INTRODUCTION

The American Gas Association (A.G.A.) is a national trade association comprising nearly 300 natural gas distribution and transmission companies serving more than 160 million consumers in all 50 states. Collectively, these companies account for nearly 85 percent of the nation's total annual gas utility sales.

A.G.A. is pleased to submit its views on the President's tax reform proposals. We support the general concept of simplifying our tax system by implementing a modified flat tax plan. Further, we recognize that lowering tax rates requires modifying certain deductions and credits, and these are important steps to take in such tax reform efforts. However, several provisions of the President's Proposals to the Congress for Fairness, Growth and Simplicity (Treasury II) cause us a good deal of concern, and our views on these provisions are described below.

Our support for the general concept of enacting a modified flat tax plan requires us to view the various provisions of Treasury II with respect to three broad areas of gas industry concern: (1) regulatory impact; (2) transitional rules; and, (3) technical recommendations. Our discussion of the individual provisions of Treasury II incorporates these three concerns. Specifically, we point out certain concerns about proper regulatory treatment with regard to capital cost recovery, the investment tax credit, and the repeal of the bad debt reserve deduction. Transition rules should be addressed in connection with the tax rate reduction, depreciation recapture, and repeal of investment tax credit proposals. A technical recommendation is offered with respect to the corporate minimum tax.

In light of the substantial federal budget deficits that are projected for the next several years, A.G.A. believes that it is important to keep the focus of tax reform efforts on true tax reform. Thus, we support the principle that tax reform efforts should be revenue neutral and should not be used as a vehicle for deficit reduction.

SPECIFIC CONCERNS OF A.G.A.

Rate Reduction

A.G.A. supports the proposal in Treasury II to reduce corporate tax rates from the current top level of 46 percent to 33 percent. Dean Witter, in a recent study, found that the effective tax rate of the natural gas industry in 1983 was in excess of 44 percent, far above the approximately 16%

for general industry estimated by the Joint Tax Committee. Thus, lower taxes, on the surface, would increase the equitable distribution of corporate taxes.

Regulated companies are in a somewhat different position than non-regulated companies, however, and require normalization rules to address certain consequences that would result from this tax rate reduction. Most companies using generally accepted accounting principles provide for deferred tax liability in reserve accounts. When these deferred taxes come due, the reserve accounts are reduced by amounts needed to meet actual tax liability in excess of the provision on the books. This is called normalization. In this manner, tax expenses associated with the use of property are spread equitably among the present and future customers of a regulated company.

In the event that corporate tax rates are reduced from the current level of 46 percent, regulatory commissions may order an immediate return to existing customers of a regulated company of that portion of the accrued deferred taxes that is in excess of the deferred amounts needed to meet tax liability at a lower rate and which is not subject to the proposed windfall recapture rule. Such an order to distribute the balance in these accounts attributable to the rate differential to customers over a very compressed period of time would generally exceed available corporate cash flow. Therefore, A.G.A. recommends that the proposal contain rules which detail legislatively the treatment of the amounts set aside as deferred taxes. A reasonable approach would require this distribution to be pegged to the life of the property that generated the deferred taxes.

The importance of legislative guidance in this area is highlighted by the fact that no definitive instructions have been offered by the Treasury Department or Internal Revenue Service on the much smaller rate reduction enacted in 1979.

Depreciation

As the members of this Committee know, the natural gas industry is a capital intensive industry. As such, the industry needs a rapid recovery of investment in productive equipment to provide funds for expansion and operations. Thus, a depreciation schedule for capital equipment that allows costs to be recovered over a relatively short period of time aids the natural gas industry in making the investments necessary to provide service to our customers.

Even though the capital cost recovery schedules proposed in Treasury II would alter the capital cost recovery periods contained in the tax code, the proposal would be acceptable to A.G.A. if it is needed to make the overall plan revenue neutral.

Our endorsement is qualified in certain important respects, however. First, and of utmost importance, A.G.A. can support a modified depreciation schedule only if appropriate legislative language is included (as mentioned in the proposal) to continue the mandatory normalization of tax reductions attributable to capital cost recovery.

Normalization language is already contained in sections 167(l) and 168(e)(3) of the Internal Revenue Code and is required to assure that the companies and the ratepayers share the benefits of accelerated depreciation.

Normalization is employed by regulated companies when there are timing differences between when deductions and credits are recognized for tax return and ratemaking purposes. That is, in the early years of the life of an asset, the tax benefits that flow from accelerated depreciation allow currently payable tax liability to remain lower than the total tax expense that is charged to income and recovered in rates. The amount equal to the tax provisions billed in rates that is attributable to this difference and that is not currently paid in tax liability is credited to a deferred tax account. In later years, when the tax depreciation is less than the depreciation used for ratemaking purposes, the deferred tax account is debited with the amount by which currently payable taxes are in excess of taxes charged to income and recovered in rates. Thus, tax liability over the life of the asset is unchanged, but use of the special account to match tax benefits with the assets to which they are attributable accomplishes a specific goal: it meets the regulatory requirement of allocating the cost of equipment purchased by a regulated company among all the customers (present and future) who benefit from the use of that equipment.

Our second concern lies with the burden that

Treasury II would place on taxpayers to increase the multiple sets of depreciation records that must be kept. Under this plan, taxpayers would be required to maintain depreciation records under pre-1981 methods, ACRS, the new Capital Cost Recovery System (CCRS), the previously proposed Real Cost Recovery System (RCRS), earnings and profits depreciation, and straight-line depreciaton (for real estate). A.G.A. believes that the use of these various depreciation methods would represent an unreasonable burden to corporate taxpayers, and would, in the case of regulated utilities, increase the cost of service to customers. Any change in depreciation provisions should require all depreciation records to be kept in accordance with pre-1981 methods, ACRS, and CCRS. References to RCRS or other methods of depreciation should be eliminated.

Finally, with respect to Treasury II, the CCRS system would require the first year depreciation rate to be prorated based upon the number of months an asset was placed in service. This would increase complexities in tax compliance that would be unnecessary if a mid-year convention were employed for the first year in which an asset is placed in service. A.G.A. recommends that this proposal be modified to retain the use of a mid-year convention in the year an asset is acquired or placed in service.

Depreciation Recapture

Treasury II asserts that a reduction in corporate tax rates would lead to a "windfall" because rapid recovery of investment through depreciation deductions has deferred the taxation of income. The "windfall" occurs because the "deferred income" would be taxed at a lower rate under Treasury II than the rate at which it would have been taxed had there been no rate reduction. To prevent this windfall, Treasury II would require that taxpayers include in income, over a three year period, a portion of the accelerated depreciation deductions taken in prior years.

A.G.A. understands the Treasury Department's rationale for proposing this tax. However, the economics of many past and current projects are determined using currently applicable ACRS rates of depreciation. To subject depreciation allowances to the "windfall" tax of Treasury II would severely alter the economics of these projects by reducing the funds available for reinvestment. A.G.A. recommends that, if this provision must be included in legislation, a pay back period of more than three years should be permitted. The detrimental effects on capital intensive industries would be reduced by such an extended pay back period which more closely achieves the anticipated benefits of the existing depreciation systems. We also recommend that language be inserted into the Committee's report to indicate that it is the intent of the Committee that the payment of the "windfall" tax will be treated as a deduction in the taxpayer's deferred tax account. Such language would help ensure that regulatory commissions would allow regulated companies the same treatment as unregulated taxpayers. Moreover, we point out that the actual calculation of this recapture under Treasury II may recover significantly more than the alleged benefit of accelerated depreciation for 15-year public utility property. If such a provision is enacted, we ask the Committee to study carefully the appropriate "windfall recapture" calculations.

Corporate Minimum Tax

A.G.A. does not oppose the concept of a corporate minimum tax when such a tax merely affects the timing of a corporation's tax liability. We do take exception to the fact that Treasury II could result in tax liability in excess of the proposed 33 percent rate. The additional tax liability results because the minimum tax is calculated for the most part with reference to certain preference items that defer tax liability. To eliminate this additional taxation, A.G.A. recommends that corporations be allowed to credit the alternative minimum tax against their subsequent years' regular tax. This credit is in accordance with the Senate Finance Committee's 1982 proposal for a minimum tax.

Tax Credits

A.G.A. does not support the elimination of tax credits that stimulate investment or energy supplies, such as the investment tax credit and the credit for producing fuel from nonconventional sources.

With regard to the investment tax credit, the regulated natural gas industry is expected to require $289 billion for investment in capital assets by the year 2000. The investment tax credit can supply a significant portion of this capital requirement, which would otherwise have to be met via potentially more costly means.

Moreover, many new facilities incorporate developing technology, the economics of which are somewhat uncertain, into their construction. However, the economics of these facilities depend heavily on certain tax benefits such as the investment tax credit and the credit for producing fuel from nonconventional sources.

If the investment tax credit must be modified, we suggest that the amount of the credit be reduced from 10% to 7%, or that the amount allowed to offset tax in any year be reduced to 50% of tax liability. If the investment tax credit must be repealed, then the effective date of any repeal provision should provide for liberal transitional rules to protect taxpayers who have incurred substantial commitments made in reliance on current law.

An appropriate transition rule would allow the credit where projects have commenced construction, where substantial expenditures and commitments have been incurred in reliance on such credits, or where regulatory approval for a project is pending. In this regard, Treasury II contains an important provision which we support: it would retain normalization rules for the unamortized portion of pre-repeal investment tax credits of regulated public utilities.

With regard to tax credits for fuels produced from nonconventional sources, Treasury II would terminate the credit earlier than current law allows. Changing statutory provisions that were relied upon in making energy project investments penalizes taxpayers who relied upon these rules and the encouragement of the Federal Government in making these investments.

Intangible Drilling Costs

A.G.A. supports the current tax treatment with respect to intangible drilling costs (IDCs). We believe that current year expensing of these costs provides the necessary incentive for exploration and production activities that result in additions to domestic reserves of oil and natural gas and help to hold down world-wide prices. Energy security requires a policy that encourages development of new oil and gas resources.

The Interstate Oil Compact Commission (IOCC) published a report early this year that illustrates the detrimental effects on gas and oil production that would result from repealing expensing of IDCs. That report, Impact of Tax Simplificaton Proposals on Oil and Gas Production and the Economy, examined the effect of repealing expensing of IDCs for the period 1986-1991. The report concluded, among other things, that this provision would result in 30,196 fewer gas and oil wells being drilled each year, that 1,085 fewer rigs would be running annually, and that reserve additions would be reduced by 5,607,000,000 barrels of oil equivalent during the six year period. The reduced drilling would result in a drop in daily production of 757,494 barrels of oil equivalent. Clearly, reductions in drilling and reserve additions of this magnitude would have a detrimental effect on developing new supplies of gas in the future as current supplies are depleted.

Dividends Paid Deduction

A.G.A. supports the Treasury II proposal to allow a deduction for 10 percent of the amount of dividends paid. Rules should be enacted, however, to assure that state regulatory bodies do not require that the benefit of the deduction be passed on to the ratepayer in an amount which exceeds that paid to the public shareholders. This situation could occur when a regulated subsidiary pays a dividend to its parent which exceeds the dividend paid by the parent to its shareholders.

Reserve Method for Bad Debts

A.G.A. opposes the Treasury II proposal to repeal the reserve method for bad debt deductions since this would effectively preclude many regulated companies from obtaining a current deduction. Eliminating this method would allow a deduction for bad debts as they occur and are written off the books. However, some regulatory commissions do not permit utility companies to characterize overdue accounts as bad debts and write them off the books if a customer is paying so much as only a small percentage of his account. This procedure is followed even in cases where the percentage paid on account is so small and the payments so erratic that it is obvious the account will never be fully paid. As a result, some companies are precluded from claiming that they incur actual bad debts. Their only recourse for recovering this substantial and growing cost of doing business is to deduct additions to a bad debt reserve. Hence, elimination of the deduction for additions to a bad debt reserve account would effectively prevent these companies from recovering any allowance for bad debts.

Employee Benefits

A.G.A. points out that the Treasury II proposal to tax employee benefits that are currently untaxed will likely lead to employee demands for increased wages to cover the amount of tax paid by the employees. This would have the undesirable side-effect of increasing costs to the employer, who would then have an incentive to recover such costs from customers. We encourage this Committee to consider carefully the effects on the economy of this upward pressure on wages.

A.G.A. believes that the principle of encouraging individuals to provide for their own retirement and support of their families should be a guiding force in structuring tax policy with respect to employee benefits. To provide this encouragement, tax policy should recognize that the workforce is changing demographically, and tax policy should be flexible enough to adapt to these changes. For instance, A.G.A. member companies have traditionally had a workforce that has relied heavily on pensions and supplementary retirement incentives. Our companies will find increasing diversity in the types of employees on the payroll in the future, however, and employee benefit programs should allow for changing interests on the part of employees as well as changes in the work environment.

Using these principles, A.G.A.'s concerns reside mainly with certain provisions of Treasury II. These concerns are as follows:

- Health Care Insurance

  This tax adds administrative recordkeeping requirements for employers. Health care cost containment has been managed well by employers, who encourage good health care on a cost effective basis. The incentive for good health care could be adversely affected if this proposal would lead to disincentives to participate in employer-provided health care plans.

- 401(k) Plans

  The Treasury II proposal, as recently modified by the Reagan Administration, would repeal these plans. Eliminating 401(k) plans would undercut the goals of encouraging individuals to plan for their retirement and providing sufficient flexibility to allow for pension mobility.

- Tax Favored Retirement Plans

  The Treasury II proposal to eliminate special tax treatment for lump sum distributions should receive careful study prior to any legislative change. The purpose of the proposal is to provide equal treatment to all taxpayers. However, this equal treatment would be obtained by seemingly disadvantaging some individuals compared to their current position. According to Treasury II, allowing distributions from tax favored retirement plans to be rolled over into IRAs mitigates the tax effect of receiving the distribution all in one year. However, the special treatment of lump sum distributions does not appear to be entirely unwarranted even with the significant self-help measures that stem from the proliferation of IRAs.

Dividend Reinvestment Plans

Treasury II would allow the expiration of tax-deferred original issue dividend reinvestment plans (DRPs). A.G.A. supports H.R. 654, a bill introduced early this year by Representatives J.J. Pickle and Bill Frenzel to extend and expand DRPs. As noted above, the natural gas industry will have capital requirements of approximately $289 billion by the year 2000. We support extending and expanding the DRPs program because it has proven to be an effective method of raising capital.

Shareholder participation in DRPs shows the popularity of these plans. The sum of reinvested dividends and cash option payments raised through qualified plans rose from

$393.5 million in 1981 to $921.4 million in 1984. Shareholder participation increased from 17 percent in 1981 to 29 percent in 1984; over one million shareholders now participate in gas industry DRPs. Further, 45 percent of shareholders participating in DRPs own less than 100 shares and over 67 percent of DRP participants own less than 200 shares.

SUMMARY

A.G.A. generally supports the current tax reform efforts. Although these reform efforts must modify most deductions and credits, certain provisions of the tax code serve legitimate economic or social policy goals and should be retained for those purposes. Moreover, transition rules should be structured to accommodate reliance on currently applicable statutory provisions. Finally, regulated natural gas companies require particular important provisions, including the historically supported normalization of accelerated tax benefits, to ensure that the intent of Congress is carried out in the tax code. We are recommending the inclusion of specific legislative or Report language to address these areas where Congressional intent might not be realized for regulated industries. A.G.A. looks forward to working with you and your staff to develop language that would accommodate these recommendations.

STATEMENT OF RAYMOND W. SMITH, VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER, BELL ATLANTIC, PHILADELPHIA, PA; ON BEHALF OF THE UNITED STATES TELEPHONE ASSOCIATION

Senator SYMMS. Mr. Smith.

Mr. SMITH. Thank you very much. My name is Ray Smith. I'm vice chairman, chief financial officer of Bell Atlantic Corp. I'm testifying today on behalf of both Bell Atlantic and the United States Telephone Association.

Bell Atlantic has filed a written statement that details our position, which I will summarize.

To begin with, I'm not here asking for special favors that would enable my industry to pay little or no Federal taxes. On the contrary, local telephone companies pay billions in taxes yearly and Bell Atlantic's effective tax rate for the next 5 years is projected to approach 30 percent. Based on 1984 results, that will mean over $2 billion in taxes paid from just one company.

The telecommunications industry is a key part of the Nation's economic infrastructure. It's vital to future growth in jobs and output. This year alone, we will invest over $19 billion in capital projects.

Now all of us have been sensitive to the problems caused by divestiture, and it would be a shame to send more shock waves through the industry with ill-advised changes in the Tax Code.

By eliminating capital investment incentives, such as the investment tax credit, the President's proposal will significantly increase the cost of capital programs and will slow development of our country's telecommunications network. As written, the proposal would hurt investment, growth and, I fear, cost this country jobs.

Furthermore, I would point out that for telephone companies, unlike unregulated companies, the tax savings resulting from the proposed corporate rate reduction may not offset the loss of capital investment incentives.

This is because these tax savings would be used to provide immediate short-term rate reductions, and wouldn't be available for network maintenance and expansion and modernization.

In other words, the telephone industry would lose both the capital incentives and the tax benefits.

The President's proposal would also cause regulated companies to lose capital because unlike the current law, it fails to adequately address the issue of normalization. Normalization is an accounting principle that spreads the tax benefits derived from capital investment incentives over the life of the assets used to provide service. Under normalization rules, tax benefits are used to reduce rates over the lives of the assets. The President's proposal addresses normalization of depreciation, but it doesn't go far enough.

Fortunately, this can be easily fixed and would not cost the Government a cent. The tax rate reduction could result in excess reserves because deferred taxes will be repaid at a lower rate than originally planned. These reserves, we feel, should be normalized.

Normalization should also be extended to include the inflation adjustment, indexing, in the proposed capital cost recovery system. Here, again, absent normalization, short-term rate reductions could again eliminate this source of funds for capital investment and for benefits to customers in the future.

The need for normalization has been recognized by this committee and the Congress since 1969. What we ask is that the committee continue to be sensitive to the need of regulated companies for normalization as it addresses tax reform legislation.

Before I close, I would like to touch on two other problems with the President's plan. First, we take issue with how the President in his proposal classifies central office equipment for depreciation purposes. Our central offices are computers and should be classified as computers; not communications equipment. Our huge switching machines are identical to computers used in manufacturing, data processing and service industries. The distinction is outdated.

And last but not least, we strongly oppose the depreciation recapture tax. It's a retroactive tax that unfairly penalizes businesses for acting in good faith based on the 1981 Economic Recovery Tax Act.

To sum up, one, I urge this committee to fully consider how the President's proposal will hurt capital-intensive industries and the jobs and international competitiveness that they represent. And, two, I urge that you consider the effect on the capital programs of regulated companies as they strive to serve the public. Bell Atlantic alone would lose $2 billion in investment over the next 5 years.

And then, finally, a reminder. We are not here asking for special tax treatment; just treatment that will allow us to ensure that our customers today and tomorrow will receive the level and quality of service that they expect.

Thank you very much.

Senator SYMMS. Thank you very much.

[The prepared written statement of Mr. Smith follows:]

WRITTEN STATEMENT
OF
RAYMOND W. SMITH
VICE CHAIRMAN OF THE BOARD
AND
CHIEF FINANCIAL OFFICER
BELL ATLANTIC CORPORATION

ON BEHALF OF

BELL ATLANTIC CORPORATION
AND THE
UNITED STATES TELEPHONE ASSOCIATION

BEFORE THE
FINANCE COMMITTEE
OF THE
UNITED STATES SENATE
ON
THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY

OCTOBER 3, 1985

DESCRIPTION OF BELL ATLANTIC CORPORATION

My name is Raymond W. Smith. I am Vice Chairman and Chief Financial Officer of Bell Atlantic Corporation, which is headquartered in Philadelphia, Pennsylvania. Bell Atlantic Corporation is a holding company created as a result of the 1984 breakup of the former Bell System. We are owned by more than 1.5 million shareowners, well over one million of whom own fewer than 50 shares.

I am testifying on behalf of both Bell Atlantic and the United States Telephone Association. Bell Atlantic's primary business is the provision of efficient, state-of-the-art, reliable local exchange, toll and exchange access services through our seven telephone company subsidiaries: New Jersey Bell Telephone Company, The Bell Telephone Company of Pennsylvania, The Diamond State Telephone Company (which serves Delaware), and The Chesapeake and Potomac Telephone Companies (which serve Maryland, Virginia, West Virginia, and the District of Columbia). Bell Atlantic also provides ancillary services such as directory advertising and billing. Our regulated operating telephone companies generate over 94 percent of our revenue and serve a population of more than 27 million people in the Mid-Atlantic region; the companies have approximately 15 million lines in service.

Bell Atlantic strongly supports the goals of the President's tax reform proposal -- namely, fairness, growth and simplicity. We also believe the President's plan could provide a focus for tax reform. We cannot, however, support the President's proposal as it stands.

Before discussing the specifics of the President's proposal, I will outline Bell Atlantic's general position on tax reform, highlighting three issues: 1) the adverse effects of the President's proposal on regulated companies as compared to unregulated companies; 2) the proposed treatment of normalization; 3) the capital-intensive nature of the telecommunications industry. I will discuss our four most significant problems with the President's proposal, along with our recommendations, in the second part of this Statement.

BELL ATLANTIC'S POSITION ON TAX REFORM

We believe that tax reform legislation should:

- be fair -- fair to individual taxpayers and fair to, and among, businesses -- regulated as well as unregulated.
- support the current pace of technological development in the telecommunications industry. The United States is a world leader in this industry, and our telecommunications infrastructure is vital to consumers and to the U.S. economy as a whole.
- promote sustained economic growth and resulting employment and not disrupt the financial markets. This is particularly true when the economy is beginning to show signs of a slowdown.

When measured against these criteria, we find we cannot support the President's proposal in its entirety. In fact, as written the current proposal would negatively affect investment, growth and employment -- so much so, that the current economic sluggishness could very well grow into a recession if the proposal were adopted. I believe that the general lack of support for this proposal is based on an understanding that investment means jobs. I fear that this proposal would cost this country jobs, precious jobs that it can ill afford to lose.

Fairness

In an effort to level the playing field between service industries and capital-intensive industries, the President has proposed to lower the corporate tax rate from 46 percent to 33 percent. We support this reduction. As a regulated business, however, we are concerned that -- unlike unregulated businesses -- the resulting tax savings will not offset the loss of current capital investment incentives such as the Investment Tax Credit. This inequitable situation is possible because the tax savings resulting from the lower tax rate probably will be used by our regulators to provide short term reductions in customer rates, rather than leave the savings available for network maintenance, expansion and modernization. We are concerned about this loss of capital because, while we are committed to providing reasonable rates for existing customers, we are no less committed to the proposition that future customers also should receive high quality, reliable service at reasonable rates.

The President's proposal would further cause us to lose capital because -- unlike current law -- it fails to address adequately the issue of "normalization". Normalization is a financial accounting and regulatory principle that, in effect, spreads the tax benefits derived from capital investment incentives over the prospective ratemaking life of the assets used to provide service. Normalization means that tomorrow's customers, as well as today's, will benefit from the incentives attributable to a given asset.

Absent requirements to normalize the tax benefits of the depreciation indexing proposed in the President's Capital Cost Recovery System (CCRS) and of excess deferred tax reserves created by tax rate reductions, a disproportionate share of these benefits could be, and most likely will be, flowed-through immediately to current ratepayers by our regulators. Normalization would allow this capital to remain available as a source of funds for capital investment and for steady flow-through to ratepayers in the future. Lack of normalization disadvantages regulated companies, as compared to unregulated companies, because the latter will not be deprived of the flexibility to use these tax benefits as business circumstances dictate.

Another inequity in the President's proposal results from its failure to categorize central office equipment as computers. This failure places the regulated telephone companies and their customers in an unfavorable position with respect to other industries. Our central offices are simply large computers that we use to switch communications traffic and should be classified with computers rather than with other "communications equipment."

Finally, we think the President!s proposed Depreciation Recapture Tax is unfair because it is retroactive and penalizes businesses for acting in good faith on the capital incentives contained in the 1981 Economic Recovery Tax Act.

Development of Telecommunications Industry

By eliminating long-standing capital investment incentives, the President's proposal also may slow the pace of development in the telecommunications industry, harming consumers and the nation's economy as a whole. The telecommunications industry, which is one of the nation's largest, is an integral part of the economic infrastructure upon which future growth in jobs and output depends. The extent of economic activity supported by the Bell Atlantic telephone companies within the Mid-Atlantic region is substantial -- over $15 billion annually and growing. This reflects both the direct output of the company and its impact on the output of other firms using telecommunications services as part of their production process. In addition to Bell Atlantic's own 73,000 employees, we estimate that another 56,000 jobs in other industries within the region owe their existence to the economic activity generated by our company in its role as part of the economic infrastructure.

Meeting the telecommunications demands of the Mid-Atlantic region is a considerable undertaking. Bell Atlantic's telephone companies serve four of the 15 most densely populated metropolitan areas in the United States; in

1984, our region had a gross product of $470 billion, making it on a stand-alone basis the 6th largest economy in the free world.

Our regional economy is not just large; it is technologically advanced as well. More than 70 of the Fortune 500 corporations are headquartered in our region, where many federal, state and local government installations also are located. We have another "silicon valley" of hi-tech firms emerging in Philadelphia's western suburbs. There are many hi-tech, service and defense-related firms clustered around Washington, D.C., which are heavy users of telecommunications services. The National Science Foundation is planning to build two research-oriented, super-computer centers -- one in Pittsburgh and another in Princeton, New Jersey. Researchers from around the nation will want access to these computers via our telecommunications network. These are just a few examples of the many large, sophisticated customers in our region. These customers require state-of-the-art telecommunications service and technology, with high-speed data transmission capabilities.

Maintaining, expanding and modernizing Bell Atlantic's telecommunications network to meet the demands of the average ratepayer as well as the sophisticated user requires huge amounts of capital; in 1984 alone, we spent nearly $1.9 billion to do so. We invested $700 million to install state-of-the-art, digital technology such as fiber cable systems and digital switching equipment. The remaining

$1.2 billion was spent on other expansion, maintenance and modernizing programs.

We have invested large sums of money to provide "equal access" to our customers. In order to encourage competition among long distance companies, the agreement that broke up the former Bell System requires our local telephone companies to provide customers access to long distance companies that is equal in simplicity and quality to that provided to customers of AT&T. We have moved quickly to meet this requirement and, in accordance with court orders, 80 percent of our customer lines will have been converted to equal access by September 1986.

In addition, we have invested and will continue to invest in the technology-driven services our major customers need so that they remain on our network and contribute to holding down the cost of local service for our millions of residential and small business customers.

In making such investment decisions, our telephone companies have relied heavily on capital formation incentives in existing tax law to upgrade and modernize our basic telecommunications networks. In 1984, over 20 percent of our $1.9 billion capital program was funded with cash generated from the Investment Tax Credit and the Accelerated Cost Recovery System (ACRS). These funds have been critical to our ability to satisfy economically the telecommunications needs of our customers.

Sustaining Economic Growth

By repealing long-standing capital investment incentives, the President's proposal will add to the sluggishness that is showing in the economy. Signs of economic slowdown are abundant:

- during the first half of this year, real GNP rose only at a 1.1 percent annual rate, compared to 6.8 percent in 1984, and 6.0 percent during the first two years of the current recovery.
- during the first half of 1985, growth in business investment was less than half the rate for the first two years of the current recovery -- 6.1 versus 15.1 percent.
- even proponents of the President's tax plan recognize the slowdown, as is evident from the Administration's downward revisions of 1985 GNP growth -- from 5 percent earlier this year to 3 percent today. (The Congressional Budget Office's current view is 2.6 percent.)

These indicators will only worsen as companies lose cash flow for capital investment, because businesses will have to turn to the financial markets to raise capital. Such an increased demand for capital -- especially when the markets are already burdened with financing huge federal deficits -- may well cause interest rates to rise, causing the cost of financing to increase.

Furthermore, the beneficial economic results of rising capital-to-labor ratios, which are the chief cause of growth in real per capita incomes, would be retarded by the removal of incentives for capital formation. Thus, while attempting to stimulate economic growth, the President's proposal as currently written would, instead, curtail growth and weaken the infrastructure -- especially telecommunications -- upon which future economic growth is so dependent.

In short, this proposal will cost jobs. Real jobs. Jobs that would be lost to foreign competition. Jobs that would be lost due to businesses holding off on investments because of uncertainty created by constant tinkering with the tax code.

FOUR SIGNIFICANT PROBLEMS

I will now discuss four of the most significant problems we have with the President's proposal:

1. Investment Tax Credit

We strongly oppose the repeal of the Investment Tax Credit (ITC). Repeal would eliminate a major source of cash flow for Bell Atlantic's telephone companies. As a result, our external financing requirements would increase $175 million annually over the next five years, based on our current capital programs. This dramatic increase in financing requirements would negatively influence our ability to proceed with our capital programs at the level that service demands.

The ITC originally was intended by Congress to spur capital investment in ways that would: 1) modernize the country's industrial base, 2) make it more competitive in worldwide markets, and 3) provide a stimulus to employment.

The ITC has served Congress's purpose well, and we ask that it be continued. We urge this Committee to assess carefully the costs to business and to the nation's economy that the elimination of the ITC would entail.

2. Depreciation Recapture Tax

The President's proposal calls for the imposition of a tax, payable over three years, on "recaptured" income that is to be calculated at 40 percent of the difference between straight-line and accelerated depreciation taken on plant additions made during the period 1980-1986.

We strongly oppose this so-called "windfall tax" because it is a retroactive tax on investments made in contemplation of entirely different tax treatment. If enacted, it will result in our loss of more than $400 million in capital over the next three years -- capital we need to maintain and upgrade our plant to serve our existing customers and to attract new ones. But, more significantly, we think it unfairly penalizes businesses for having made the most of existing capital incentives for the benefit of their customers.

3. Categorizing Central Office Equipment

Under the President's proposal, telecommunications equipment is categorized without respect to whether it is owned by a regulated or an unregulated company. We support this approach, because we think it recognizes the emerging competitive realities of today's telecommunications industry that stem from the convergence of the telecommunications and computer industries.

Central office equipment, however, should be categorized as CCRS Class 2 with computers, rather than as CCRS Class 4 with other "communications equipment." The central office equipment that serves our modern network consists of large, general purpose computers that we engineer and program to switch communications traffic. Our switches fundamentally are identical to computers used in manufacturing, data processing and service industries; our equipment is subject to similar technological obsolesence and has comparable residual values. Like assets should be treated alike.

Proper classification of our central office equipment under the President's proposal will increase our capital investment resources on average by as much as $100 million annually over the next five years.

4. Normalization Treatment for Depreciation Indexing and Deferred Tax Reserves

The President proposes to replace the Accelerated Cost Recovery System (ACRS) with the Capital Cost Recovery System (CCRS). CCRS is designed to preserve investment incentives while explicitly accounting for inflation and different rates of economic depreciation.

We are gratified that the proposal recognizes the need for normalization for CCRS investment incentives comparable to those under ACRS. We would like to be sure, however, that normalization is extended to cover depreciation indexing for inflation as well.

The President's proposed CCRS contains a component that specifically accounts for the effects of inflation. This provision, as we understand it, was included in CCRS to protect investments in depreciable assets from the effects of inflation. If it works as intended, this proposal will forestall the need for accelerated cost recovery rules at some future date. The ACRS was enacted precisely because businesses had to catch up with the effects of the high inflation of the late 1970s. But as the CCRS proposal now stands for regulated utilities, the benefits of indexing tax depreciation will probably be flowed-through to today's customer's at the expense of tomorrow's.

Without provisions that require the normalization of indexing, the resulting tax benefit will almost certainly be used immediately to reduce income tax expense for ratemaking purposes. Failure to normalize depreciation indexing will mean that -- depending on the inflation rate -- as much as $70 million less each year will be available for our capital programs as the embedded CCRS base grows. In contrast, unregulated companies, which are free to set their own prices, will have the tax benefits available for capital investment purposes.

In order to place local telephone companies and utilities in general on an equal footing with other industries, a provision similar to the provision covering ITC in current tax law should be added to the President's proposal, requiring the normalization of the tax benefits of depreciation indexing.

For example, to achieve the positive effects of normalization for the CCRS indexing provisions, the tax benefit could be placed in a deferred account that could not be used to reduce a telephone company's rate base. The benefit accumulated in the account could then be used to reduce the income tax expense recovered in customer rates over the entire ratemaking life of the underlying assets. Meanwhile, the funds in the deferred account would be available to the regulated utility as a source of capital for network maintenance, expansion and modernization.

Another normalization issue is created by the President's proposal to reduce the corporate tax rate from 46 percent to 33 percent effective July 1, 1986. The tax rate cut will result in an "excess" of deferred tax reserves because the deferred taxes will be repaid at a lower rate than originally planned when the reserves were first established.

To date, these deferred reserves -- which built up under past and current laws -- have been a source of funds for capital investment and prospective cost-of-service reductions. After an investment is made, taxes that were deferred in the initial years when the reserves were built up are paid back over the later years of the asset's life.

Most unregulated companies would benefit from the proposed tax rate reduction because they would be able to retain the difference in deferred tax reserves as funds that could be used to support existing capital investment or to adjust prices. Regulated companies, however, most likely will be required by regulators to flow-through the excess in tax reserves to ratepayers over a period of time that is much shorter than the remaining service lives of the underlying assets. For Bell Atlantic, over $750 million of funds currently supporting network investment could be subject to accelerated flow-through.

Therefore, Bell Atlantic urges that any tax reduction enacted specify that the difference in the deferred tax reserves that results from such reduction in the corporate tax rate be normalized over the remaining lives of the related assets. This would allow the telecommunications industry to retain for a period of time some of the benefits of the tax rate reduction and help keep us on an equal footing with our competitors. It would also ensure that a reduction in the tax rate would benefit customers not only today, but in the future as well.

CONCLUSION

In summary, Bell Atlantic strongly favors tax reform that treats all taxpayers fairly, supports the current pace of development in the telecommunications industry, and promotes sustained economic growth while not disrupting financial markets.

The President's current proposal, however, does not meet these criteria. The "windfall tax" is unfairly retroactive in nature. Our central office equipment is not categorized correctly with computers. The failure to address adequately the normalization issue means that regulated companies will be at a disadvantage as compared to unregulated companies and may lose a source of funds for capital investment. Finally, the elimination of the Investment Tax Credit will have a negative effect on the financial markets and will significantly compromise the capital formation incentives that have served this country's economic goals well for nearly a quarter of a century.

The telecommunications network is a vital part of the nation's economic infrastructure and will play an even more important role in the economic growth of the United States as we evolve from a manufacturing-based to a service and information-based economy in the 1990s. We urge this Committee to fully consider the adverse effect the President's proposal will have on the capital formation needs of regulated telecommunications companies as it completes its deliberations on tax reform. For instance, repealing the ITC, imposing the "windfall" tax, and failing to extend normalization provisions to any "excess" in deferred tax reserves -- all at the same time -- would mean that Bell Atlantic would lose $1.6 billion of cash flow for capital investment over the next five years.

We are not asking for special treatment -- just treatment that will allow us to ensure that our customers receive the high quality, reliable and efficient service they deserve and expect, and to compete fairly with our competitors.

STATEMENT OF HOWARD P. DOERR, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, U.S. WEST, ENGLEWOOD, COLORADO

Senator SYMMS. Mr. Doerr, welcome to the committee. I'm glad you got out of the snowstorm in Denver.

Mr. DOERR. Thank you, Senator.

My name is Howard Doerr, and I'm the executive vice president and chief financial officer of U.S. West Corp. On behalf of U.S. West, I have already filed a written statement that details more fully our position on the President's tax proposals.

My purpose here today is to briefly share with you U.S. West's perspectives on a few specifics of the impact of the proposal on U.S. West, our employees, our shareowners and our customers.

U.S. West, as many of you know, was created as a result of the breakup of the Bell System. And it began with three established telephone companies—Mountain Bell, Northwestern Bell, and Pacific Northwest Bell.

Our assets were in excess of $17 billion at the end of 1984. And we invested $1.7 billion in 1984, and will invest an additional $2 billion this year, 1985. These investments are for providing advanced technology in the local telephone network. We will provide in 1985 alone for 290,000 new customer lines, to add state-of-the-art-switches, and to place 24,000 fiber miles of fiberoptic transmission facilities.

This investment underscores our commitment to high-quality, technically advanced telecommunications services to nearly 10 million customers throughout 14 Western States. And the commitment has been supported in part by the existing Federal Government's tax policies as it recognized three realities: No. 1, the need for capital formation in high-technology industries like ours; No. 2, the convergence of telecommunications technology with computer technology; and, No. 3, the recognition of the unique regulatory circumstances under which local telephone communication companies operate.

Enormous commitments, long-term commitments, of capital are required to serve our customers. And in the last 5 years alone, we have invested over $10 billion in this effort.

The proposals for eliminating many of the capital investment incentives will severely impact the cost of capital programs as well as the size and the growth of the future programs. The proposals further unfairly penalize businesses that follow the provisions of the 1981 Economic Recovery Act by now suggesting the imposition of a so-called excess depreciation recapture tax. Such a tax would retroactively increase the after-tax cost of past capital expenditures, and would result in a tremendous cash-flow burden for U.S. West, which we estimate to be $500 million over the next 3 years.

One final concern that I wish to comment on has to do with the classification of communications equipment for depreciation expenses. There is no fundamental difference between the technology used to provide telecommunications services and those functions performed by computers. Congress, itself, recognized this in 1981 and accordingly central office telecommunication equipment and computers are depreciated under ACRS over the same period—5 years. The administration's proposal is a step back from this level playing field, and it provides for computers to be depreciated at a rate faster than comparable equipment used in the provision of telecommunications services.

This is only one example where the treatment for depreciation of communications equipment is being authorized under unequal terms. There is a great need on the part of the legislation to recognize what are the elements of telephone plant. For example, the President's proposal recognizes the need for accelerating recovery of the investment in our outside plant over 10 years. If the recent Ways and Means staff proposal would change this recovery period to 30 years—this is amazing when you fully recognize the tremendous technical advancements that are being made in this category of our plant.

I thank you for giving me this opportunity to address these issues. And I will look forward to your questions later on.

Senator SYMMS. Thank you very much.

[The prepared statement of Mr. Doerr follows:]

STATEMENT

Of

Howard P. Doerr
Executive Vice President & Chief Financial Officer
U S WEST, Inc.

On

The Administration's Tax Reform Proposal

Before

Finance Committee
U. S. Senate

October 3, 1985

My name is Howard P. Doerr. I am Executive Vice President and Chief Financial Officer of U S WEST, Inc. Thank you for the opportunity to testify on the effects of the Administration's tax reform proposal on U S WEST. U S WEST supports the goals of tax fairness, tax simplification, and economic growth, but we are concerned that this proposal will not accomplish those goals.

This new competitive company, U S WEST, began with three established telephone companies -- Mountain Bell, Northwestern Bell, and Pacific Northwest Bell -- to provide local telecommunications to over ten million customers in the fastest growing region in the country. Divestiture of AT&T gave us the freedom to expand into new lines of business and the opportunity to become more than a telephone company. We have established unregulated subsidiaries that are in businesses ranging from real estate to cellular telephones, from providing financial services to marketing, installing, and maintaining business communication equipment. U S WEST and all its subsidiaries employ over 70,000 people nationwide.

The mainstay of U S WEST's business is telecommunications. U S WEST's assets were $17 billion at the end of 1984. U S WEST invested $1.7 billion in new plant and equipment during 1984, and plans to invest an additional $2 billion in 1985. This capital is used to deploy advanced technology in the local telephone network that provides for growth and for the introduction of innovative telecommunications services.

Pacific Northwest Bell, Mountain Bell, and Northwestern Bell added 289,000 customer access lines in 1984. They spent $323 million on state-of-the-art digital central office computers, and placed 24,000 fiber miles of fiber-optic transmission facilities. This commitment to high-quality, low-cost, technologically advanced telecommunications service to the millions of residences and businesses in our 14 states has been augmented by Federal tax policies that recognize four realities:

1. The need for capital formation incentives, particularly in high-technology industries like telecommunications;

2. The convergence of telecommunications technology with computer technology;

3. The recognition of the particular regulatory circumstances of local telecommunications companies; and

4. The importance of basic research to the strength of our nation.

In the past, Congress has recognized the importance of capital formation that reduces the cost of local telephone service by providing telecommunications companies with access to capital through the investment tax credit and accelerated depreciation. They provide a significant incentive for the U S WEST companies to invest in new plant and new technology. We are concerned that the Administration's proposal does not pay adequate attention to these past priorities, and as a result will alter drastically the economic environment for capital-intensive industries.

The communications industry is both technologically driven and capital intensive. Enormous commitments of capital are required to serve the customer with the latest technology and most cost-effective service. In the last five years, our telephone companies have invested over $10 billion in plant and equipment. In 1984-86, we will spend over $5 billion to meet growth and modernization requirements in our operating region. With our huge capital requirements, the Administration's proposal for a recapture tax on so-called "excess" depreciation is particularly unfair. This change would increase retroactively the after-tax cost of past capital expenditures, deprive capital intensive companies of near-term benefits of rate reduction, and discriminate against communications companies which have invested so heavily in new technology since 1980.

The recapture tax is a tremendous cash flow burden for us. This tax would cost U S WEST $500 million over the next three years -- funds that would otherwise have been used to serve our customers. Any delay in capital expenditures resulting from this new tax would slow improvements in the quality of telephone service. The rapid population growth in our region will only exacerbate our cash flow problem. Loss of internal cash flow of this severity would require substantial operational adjustments. The impact upon our employees, our stockholders, our suppliers, their employees, and the communities we serve would be painful.

Another area of concern is the classification of communication equipment for depreciation purposes. There is no difference between the technologies used to provide telecommunications services and those used in computers. Congress recognized this in 1981; so under ACRS computers and central office equipment are depreciated over the same period -- five years. The Administration would take a step back from this principle of fairness which was established in 1981 and is one of the principles underlying the Administration's plan. Computers would be provided a faster rate of depreciation than that provided for communication equipment. If the tax depreciation rate for computers is faster than for central office equipment, then our competitors will have a cost advantage which will encourage bypass of the local telephone company. Computers are the core of our central offices. By the end of this year, 71 percent of our customer lines will be serviced by switching machines that are computers. The historic definition of telephone switch ought to be revised to "computer." Classifications for communications must reflect the state of the technology today and not be based upon historic and outmoded concepts.

Another major area of concern for us is normalization. Normalization rules are essential to assure that the tax incentives for capital formation are shared between regulated utilities and customers. The concept of normalization of depreciation and investment credit has been recognized by Congress each time those incentives have been the subject of legislation since 1969. We are encouraged that the Administration also supports the continuation of normalization for plant and equipment investment under current law and whatever new depreciation scheme is devised.

We support the provision in the Administration's proposal to extend the credit for research and experimentation and to revise the definition of qualified research to target those research activities most likely to result in technological innovation.

As indicated earlier, technology is the heart of our business. U S WEST companies cannot wait for all innovations in communications technology to be developed by others. To keep at the forefront, we must participate actively in research and development. Although we share in important innovation developed at Bell Communications Research, we believe that it is imperative that we complement those efforts by developing additional resources for research directed toward our specific needs. This makes it critical for us that the research credit be retained in the tax code as we build our research talents.

In conclusion, U S WEST can support tax reform that:

1. Retains fair incentives for capital formation that will keep America at the forefront of telecommunications technology;

2. Maintains the current correct practice of classifying computers and central office equipment in the same depreciation class;

3. Continues the concept of normalization as an integral part of the tax code for current investment and any future capital formation incentive that Congress may devise; and

4. Retains the credit for research and development.

Thank you for the opportunity to present our views.

STATEMENT OF MICHAEL D. FOLEY, DIRECTOR OF FINANCIAL ANALYSIS, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, WASHINGTON, DC

Senator SYMMS. Mr. Foley.

Mr. FOLEY. Good morning, Mr. Chairman, and members of the committee. My name is Michael Foley, and I am the director of financial analysis for the National Association of Regulatory Utility Commissioners, commonly referred to as NARUC.

The membership of the NARUC deeply appreciates this opportunity to express our views today regarding comprehensive Federal income tax reform, as this is an issue which has a substantial direct impact on the rates which consumers ultimately pay for basic utility services. Whatever disagreements may exist among us on this panel this morning, let us at least agree on this one point. Utility companies do not pay Federal income taxes. Utility companies merely collect taxes from their ratepayers and remit a portion, and only a portion, of what they collect to the Treasury.

Thus, it is imperative that State and Federal utility regulators be granted sufficient flexibility to establish accounting and ratemaking policies which properly reflect the level of taxation imposed on this sector of our economy.

Unfortunately, previous efforts at restructuring the corporate tax burden as it relates to utility companies has created severe distortions in the ratesetting process, in that specific rate-making decisions have now been carved into Federal tax law; thus, preempting the entire State ratesetting process.

Let me provide just one simple example of the kind of distortion that has been created due to the improper inclusion of utility ratemaking language into the Federal Tax Code.

Assume, for example, that a utility company were today to go out and purchase a truck for $10,000. And that truck were to qualify for a 10-percent investment tax credit. Although the utility has immediately shelled out $10,000 for the asset, the utility is then qualified to take a $1,000 immediate reduction in the Federal taxes that it would otherwise pay. Thus, the true cost of the asset is not $10,000, but merely $9,000 after accounting for the immediate investment tax credit.

The problem arises in that current Federal tax law requires utility ratepayers to pay a full rate of return on a $10,000 asset, even though as we have seen, the asset only cost $9,000.

In actual practice, of course, the dollars involved are much greater than my hypothetical example shows. Last year, for instance, the Congressional Research Service calculated that in the electric utility industry alone consumers are paying excess rates of $2 billion due to this technical flaw in Federal Tax Code.

I should point out that the Reagan administration, to its credit, included a provision in its original 1981 Economic Recovery Tax Act that would have corrected this widely recognized technical flaw in the Federal Tax Code. But that particular provision was removed by this committee after an intense lobbying effort by the utility representatives.

The Carter administration also unsuccessfully sought to correct this problem. This is an issue of Federal tax law which simply begs for reform. For even if the ITC is abolished altogether, as the President has proposed, the unamortized credits will be on the books of the utility companies and earning a full rate of return for at least the next 30 years.

The electric utility industry has over $14 billion in unamortized credits on its books. We propose that any elimination of the investment tax credit be coupled with legislative language which cleans up this inequity.

We are also deeply concerned with a number of recent statements by certain utility trade groups regarding their desire to couple Federal tax reform with additional language which will have the effect of further distorting the ratesetting process. We were somewhat bemused at a recent press release issued by the Edison Electric Institute which claims support for the President's tax reform proposals. Yet when you read between the lines of that press release, what they are really saying is that they support it subject to certain clarifying amendments and transition rules.

Well, after you get finished with that litany of transition rules and clarifying amendments, all you have is further distortion of ratesetting policies.

In closing, let me state that we stand ready to work with this committee and its staff in working toward legitimate and realistic Federal tax reform.

Thank you again for this invitation to be here today. And I would be pleased to respond to any of your questions.

Senator SYMMS. Thank you.

[The prepared written statement of Mr. Foley follows:]

UNITED STATES SENATE
COMMITTEE ON FINANCE

TESTIMONY OF THE

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
1102 INTERSTATE COMMERCE COMMISSION BUILDING
CONSTITUTION AVENUE AND TWELFTH STREET, N.W.
POST OFFICE BOX 684, WASHINGTON, D.C. 20044
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ON

FEDERAL TAX REFORM

OCTOBER 3, 1985

Mr. Chairman and Distinguished Members of the Committee:

My name is Michael Foley and I am the Director of Financial Analysis for the National Association of Regulatory Utility Commissioners, commonly referred to as the "NARUC".

The NARUC is a quasi-governmental, non-profit organization founded in 1889. Within our membership are the governmental agencies of the fifty States, the District of Columbia, Puerto Rico and the Virgin Islands which are engaged in the regulation of utilities and carriers. Our chief objective is to serve the consumer interest by seeking to improve the quality and effectiveness of government regulation in America.

As the regulators of this nation's public utility companies, we greatly appreciate your invitation to testify on the subject of comprehensive Federal income tax reform.

The evolution of corporate tax law in recent years has been marked by an alarming tendency by Congress to preempt the ratemaking functions which historically and properly have been reserved to the State regulatory commissions. Recent utility trade press articles have noted that the industry has expressed the desire to couple Federal tax reform with a series of amendments and transition rules designed in large measure to further preempt ratemaking options.

It has always been and it remains the view of the NARUC, that the complexities of utility ratemaking are such that the objective of reaching fair and reasonable rate settlements is most readily accomplished via the open forums of the State regulatory commissions. It has been our experience that the efforts of the Congress to intervene in this process--however well intentioned--only serves to add to the regulatory burden and compromise the integrity and public confidence in the ratemaking process.

The Reagan Administration's proposal for comprehensive Federal tax reform suggests a number of new provisions for inclusion in the Internal Revenue Code while eliminating others. The ratemaking considerations associated with several of the proposed new provisions merits further discussion.

This testimony presents a broad overview of the major provisions relevant to the regulated industries and a presentation of the policies of the NARUC in response to the efforts of certain utility representatives to amend the proposal thus making it "less silent" as to the regulatory treatment of utility tax benefits.

This testimony is presented in five major sections as follows:

- Repeal of the Investment Tax Credit
- Capital Cost Recovery System (CCRS)
- Excess Depreciation Accruals
- Partial Deductibility of Dividends
- Nuclear Decommissioning Funding

The positions of the NARUC on these major provisions of the President's reform package were approved by the NARUC Executive Committee at its Summer meeting held in San Francisco, July 31-August 1, 1985.

1) **Investment Tax Credits:** Treasury statistics document that no single industry has derived greater benefit from the ITC than have the public utility companies--particularly electric utilities. Although generally supportive of the availability of the credit, the NARUC has argued before Congressional committees on numerous occasions that current Federal tax law regarding the ITC is defective in that it requires ratepayers to pay a full rate of return on the unamortized portion of the ITC (NARUC Bulletin No. 50-1979, p. 26 and 1979 Proceedings pp. 290-291).

The Department of the Treasury under both Presidents Carter and Reagan has argued before Congressional committees that Section 46(f) of the Internal Revenue Code is technically defective and in need of revision.[1] Specifically, Treasury officials, the NARUC, the Congressional Research Service, and numerous other interested parties argue that regulators ought to have the flexibility to implement a technique known as "economic normalization" of the ITC which would have the effect of treating the credit as zero cost capital thus preserving the economic stimulus of the credit in a manner which replicates the economic benefit of the ITC to non-regulated industries while at the same time providing a sharing of the ITC between both ratepayers and stockholders.

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[1] See for example the statement of Emil M. Sunley, Deputy Assistant Secretary of the Treasury for Tax Analysis, before the Subcommittee on Oversight of the U.S. House Committee on Ways and Means, March 22, 1979; and the statement of John G. Wilkins, Director of the Office of Tax Analysis of the Department of the Treasury, before the Subcommittee on Energy Conservation and Power of the U.S. House Committee on Energy and Commerce; June 12, 1984.

POLICY POSITION NUMBER 1

THE NARUC URGES THE CONGRESS TO INCLUDE WITHIN THE PROVISIONS OF ANY TRANSITION RULES RELATING TO THE ELIMINATION OF THE ITC, A SECTION WHICH CORRECTS THE WIDELY RECOGNIZED TECHNICAL FLAW IN SECTION 46(f) OF THE INTERNAL REVENUE CODE. THE INTENT OF THIS CORRECTION WOULD BE TO ENABLE REGULATORS (AT THEIR OPTION) TO IMPLEMENT "ECONOMIC NORMALIZATION" OF THE CREDIT THUS PROVIDING A MORE EQUITABLE SHARING OF ITC BENEFITS.

2) Capital Cost Recovery System: The Reagan Administration has proposed abolishing the accelerated cost recovery system (ACRS) established in 1981 and replacing it with a capital cost recovery system (CCRS).

The new CCRS would modify ACRS in two important respects. First, CCRS would allow cost recovery of the real or inflation adjusted cost of depreciable assets, rather than only the original, nominal cost. Second, CCRS would assign property among new recovery classes based upon economic depreciation rates.

Most public utility property which now is placed in the 15 year recovery class would be written off over 10 years with the exception of communications equipment which would move from its current 5 year class to a 7 year recovery period.

The proposal states simply that in recognition of the historic practice of requiring normalization of investment incentives for regulated public utilities, CCRS would contain normalization rules for regulated utilities comparable to those under ACRS.

The NARUC for many years has taken the position that the proper ratemaking treatment of depreciation allowances should be subject to the discretion of the State commissions (NARUC Bulletin No. 42-1979, pp. 8-11 and 1979 Proceedings, pp.962-966). We are concerned over the technical aspects of implementation of normalization as it relates to the new CCRS proposal as this could potentially have negative implications for ratepayers in that inflation adjusted capital cost recovery results in **permanent** tax-to-book differences as opposed to simple timing differences created under traditional cost recovery systems.

Exhibit # 1 displayed on the following page shows in a rather simplistic manner the potential problem outlined above. In Case # 1 of the exhibit, the entire deferred tax balance is eventually paid to the Treasury over the ten year book life of the asset. Stockholders benefit via increased cash flow during the interim years before the timing difference reverses in full and ratepayers benefit through a decrease in capital charges included in rates in that deferred tax balances in essence represent interest free loans from the Treasury to the utility.

However Case # 2 shows that with an inflation adjusted capital cost recovery system the full balance of deferred taxes are **not** repaid thus creating a **permanent** tax-to-book difference. The portion not repaid results from the fact that the utility is allowed depreciable deductions in excess of the historical book cost of the asset. The portion of the deferred tax balance not repaid represents collections from ratepayers ostensibly for the payment of a future tax obligation which is no longer due. Under traditional normalization procedures, it is unclear whether or not regulators would be allowed the necessary flexibility to return these funds to ratepayers either immediately or ratably

EXHIBIT # 1

CASE # 1

ASSUMPTIONS:

COST OF ASSET: $100,000
10 YEAR BOOK LIFE
5 YEAR TAX LIFE
33% MARGINAL CORPORATE RATE
STRAIGHT LINE DEPRECIATION

YEAR	DEPRECIATION (TAX)	DEPRECIATION (BOOK)	DEFERRED TAXES
1	$20,000	$10,000	$3,300
2	$20,000	$10,000	$6,600
3	$20,000	$10,000	$9,900
4	$20,000	$10,000	$13,200
5	$20,000	$10,000	$16,500
6	$0	$10,000	$13,200
7	$0	$10,000	$9,900
8	$0	$10,000	$6,600
9	$0	$10,000	$3,300
10	$0	$10,000	($0)

CASE # 2

ASSUMPTIONS:

SAME AS ABOVE EXCEPT WITH 5%
INFLATION FACTOR FOR TAX DEPRECIATION

YEAR	DEPRECIATION (TAX)	DEPRECIATION (BOOK)	DEFERRED TAXES
1	$20,000	$10,000	$3,300
2	$21,000	$10,000	$6,930
3	$22,050	$10,000	$10,907
4	$23,153	$10,000	$15,247
5	$24,310	$10,000	$19,969
6	$0	$10,000	$16,669
7	$0	$10,000	$13,369
8	$0	$10,000	$10,069
9	$0	$10,000	$6,769
10	$0	$10,000	$3,469

over the life of the asset thus providing a proper matching of actual tax expense with taxes collected from ratepayers as an element of the firm's cost of service.

The Reagan tax package is silent on the issue except to state that the normalization requirements of current tax law would be preserved. Inasmuch as the President's proposal has not been set forth in legislative language, it remains unclear whether the mechanics of traditional normalization would provide regulators sufficient flexibility to set ratemaking policies which would provide an equitable recognition of the CCRS benefits.

POLICY POSITION NUMBER 2

THE NARUC OPPOSES ANY LEGISLATIVE LANGUAGE WHICH RESTRICTS THE ABILITY OF REGULATORS TO ACCOUNT FOR THE BENEFITS CREATED UNDER THE PROPOSED CAPITAL COST RECOVERY SYSTEM (CCRS). FURTHER, THE NARUC OPPOSES IN CONCEPT THE CREATION OF AN INFLATION ADJUSTED CAPITAL COST RECOVERY SYSTEM IN THAT IT IS UNDULY COMPLEX AND COUNTER-PRODUCTIVE TO THE STATED NATIONAL GOAL OF INCOME TAX SIMPLIFICATION.

3) **Excess Depreciation Accruals:** The Administration's proposal includes a substantial reduction (from 46% to 33%) in the maximum corporate tax rate. An important question arises as to the proper tax and ratemaking treatment of the excess depreciation accruals or deferred taxes which were generated at the 46% rate which then become due to the Treasury under the proposed 33% rate.

With stable tax rates over the life of any given single asset, the amount of tax that is deferred as a result of accelerated depreciation is equal to the amount of tax that is repaid in later years.[2] However, a reduction in tax rates for the later years produces an unexpected benefit for the utility by reducing the tax that must be repaid relative to the tax that was deferred. This **unintended** benefit is in addition to the **intended** benefit of interest-free deferral of the tax liability inherent in the acceleration of deductions.

In the case of utility companies, deferred tax balances represent funds collected from customers which are payable in the future to the Federal government. However as we have seen, the proposed reduction in the marginal corporate rate creates the scenario in which a portion of deferred tax balances are no longer due the Treasury. In simplest terms--a portion of funds collected from ratepayers ostensibly for the payment of a future tax liability are no longer owed the government--not now, not ever.

The Reagan proposal provides that in order to prevent taxpayers from obtaining the unexpected windfall benefit described above, 40 percent of a taxpayer's "excess depreciation" taken between January 1, 1980, and July 1, 1986, would be included in income over a three-year period.

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[2] Note however that in the general case of growing firms new tax deferrals created via the purchase of additional assets have the effect of offsetting the actual payment of the tax liability to the Treasury. In actual practice the regulated industries have generally been able to generate sufficient **new** deferred taxes to offset the reversal of the tax liabiliity of the old assets thus increasing deferred tax balances by billions of dollars annually and reducing the **actual effective** tax rate paid by the firm to the Treasury.

The proposal is silent as to deferred taxes generated prior to 1980 and contains no language regarding the ratemaking implications of the reduction in the maximum corporate rate.

Exhibit # 2 on the following page presents a simple model which shows the practical effect of a reduction in the maximum corporate marginal tax rate from 46% to 33% assuming pre-1980 property and a change in the tax rate after the 5th year of the book life of the property. Cases # 1 and # 2 show the deferred tax balances under present law and the proposed change respectively. One will note that once again the proposal results in a situation under which the entire deferred tax balance is not paid to the Treasury. Again, these funds represent collections from customers ostensibly payable to the government which are no longer due because of the reduction in the rate. Regulators must then determine the appropriate amortization period over which to return these funds to ratepayers. It remains unclear as to whether or not post-1980 property will exhibit this same problem or whether the 40% recapture provision will essentially eliminate any excess deferrals.

In a letter to The Assistant Secretary of the Treasury for Tax Policy earlier this year the Edison Electric Institute urged that regulatory discretion in returning excess deferrals back to ratepayers be curbed via Federal legislation such that the amorti-

EXHIBIT # 2

CASE # 1

ASSUMPTIONS:

COST OF ASSET: $100,000
10 YEAR BOOK LIFE
5 YEAR TAX LIFE
46% MARGINAL CORPORATE RATE
STRAIGHT LINE DEPRECIATION
PRE-1980 PROPERTY

YEAR	DEPRECIATION (TAX)	DEPRECIATION (BOOK)	DEFERRED TAXES
1	$20,000	$10,000	$4,600
2	$20,000	$10,000	$9,200
3	$20,000	$10,000	$13,800
4	$20,000	$10,000	$18,400
5	$20,000	$10,000	$23,000
6	$0	$10,000	$18,400
7	$0	$10,000	$13,800
8	$0	$10,000	$9,200
9	$0	$10,000	$4,600
10	$0	$10,000	($0) ←

CASE # 2

ASSUMPTIONS:

SAME AS ABOVE EXCEPT WITH CUT IN MARGINAL CORPORATE RATE FROM 46% TO 33% AFTER YEAR 5

YEAR	DEPRECIATION (TAX)	DEPRECIATION (BOOK)	DEFERRED TAXES
1	$20,000	$10,000	$4,600
2	$20,000	$10,000	$9,200
3	$20,000	$10,000	$13,800
4	$20,000	$10,000	$18,400
5	$20,000	$10,000	$23,000
6	$0	$10,000	$19,700
7	$0	$10,000	$16,400
8	$0	$10,000	$13,100
9	$0	$10,000	$9,800
10	$0	$10,000	$6,500 ←

zation period could be no more rapid than the remaining life of the asset thus preventing "a windfall to consumers in the short run."[3]

POLICY POSITION NUMBER 3

THE NARUC OPPOSES ANY EFFORTS TO AMEND THE REAGAN TAX REFORM PROPOSAL WHICH WOULD HAVE THE EFFECT OF RESTRICTING REGULATORY FLEXIBILITY IN DETERMINING THE PROPER AMORTIZATION PERIOD FOR RETURNING TO RATEPAYERS THE EXCESS DEFERRED TAXES WHICH RESULT FROM THE PROPOSED REDUCTION IN THE MAXIMUM MARGINAL CORPORATE TAX RATE.

4) **Partial Deductibility of Dividends:** The double taxation of corporate earnings would be partially relieved under the Administration proposal by allowing corporations a deduction equal to 10 percent of dividends paid to their shareholders ("dividends paid deduction"). The proposal is silent as to the ratemaking treatment of such a deduction. Presumably, any tax savings generated would be directly flowed through to ratepayers in that there are no tax-to-book timing differences involved. Such is generally the case with other tax deductible expenses such as labor, purchased power, etc..

Mr. William Berry, Chairman and Chief Executive Officer of Dominion Resources, Inc. (Virginia Electric Power Co.) testified before a recent hearing of the Senate Finance Committee that in his view the "Dividends Paid Deduction" would be directly flowed through to consumers. However, other utility representatives have expressed concerns on this issue and have argued that the reform proposal will not correct the double taxation problem in the case of regulated industries unless Federal tax law specifically restricts the ability of regulators to pass the tax break onto ratepayers.

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[3] February 15, 1985 Letter of the Edison Electric Institute to Mr. Ronald A. Pearlman; Assistant Secretary of the Treasury for Tax Policy; P.4.

The NARUC has been an advocate in the past of an additional approach to the problem of double taxation of corporate earnings. The Economic Recovery Tax Act of 1981 contained a provision supported by the NARUC which provides for tax deferrals for dividends reinvested into qualified dividend reinvestment plans (NARUC Bulletin, No. 20-1981, pp. 15-18 and 1981 Proceedings, pp. 925-934). This particular provision of the Internal Revenue Code is scheduled to expire at year end 1985. Given the enormous success of dividend reinvestment programs at raising substantial sums of capital, the NARUC favors efforts to make this provision a permanent feature of the Federal tax code.

POLICY POSITION NUMBER 4

THE NARUC OPPOSES ANY EFFORTS TO RESTRICT REGULATORY FLEXIBILITY IN ACCOUNTING FOR THE EFFECTS OF THE PROPOSED "DIVIDENDS PAID DEDUCTION".

POLICY POSITION NUMBER 5

THE NARUC ENCOURAGES THE PERMANENT RETENTION IN THE INTERNAL REVENUE CODE, THE TEMPORARY PROVISION CREATED UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 WHICH PROVIDES FOR TAX DEFERRALS FOR DIVIDENDS REINVESTED INTO QUALIFIED DIVIDEND REINVESTMENT PLANS.

5) **Nuclear Decommissioning Funding:** For several years the NARUC has advocated an amendment to the tax code which would allow a deduction for accruals to reserves for nuclear power plant decommissioning (1982 Proceedings, pp. 1187-88). The 1984 tax act contained an extremely limited provision which partially

addresses this issue. However new legislation has been introduced in both the House and Senate and endorsed by the NARUC which would properly clear up this deficiency in the tax law (NARUC Bulletin, No. 16-1985, pp. 4-6).

POLICY POSITION NUMBER 6

THE NARUC URGES CONGRESS TO INCLUDE THE PROVISIONS OF H.R. 1619 (REP. GIBBONS; D-FLA.) IN THE COMPREHENSIVE REFORM PACKAGE TO PROVIDE A CURRENT TAX DEDUCTION FOR ACCRUALS TO RESERVES FOR NUCLEAR POWER PLANT DECOMMISSIONING.

CONCLUSION

The NARUC advocates the widest possible flexibility in accounting for the effects of corporate tax benefits to public utility companies. Accordingly, the NARUC opposes the stated goals of the utility interests to compromise the simplification of Federal tax law by coupling it with language which restricts the ability of utility regulators to properly set rates which reflect the effect of the tax benefits.

We would be pleased to provide additional information to the Committee on our position as needed. Moreover, we would like to work with this Committee and its staff in an effort to assess the merits of those provisions of Federal tax law (both current and proposed) which affect public utility companies.

Senator SYMMS. Mr. Morgan.

STATEMENT OF RICHARD E. MORGAN, STAFF ECONOMIST, ENVIRONMENTAL ACTION, WASHINGTON, DC

Mr. MORGAN. Thank you, Mr. Chairman, members of the committee. My name is Richard E. Morgan. I'm an economist with Environmental Action. My testimony concerns the impact of the President's Treasury II plan on electric utilities.

Probably no other industry would be treated more favorably by Treasury II than the electric utility industry. There is a strong possibility, in fact, that this industry may experience a negative income tax under Treasury II. A Department of Energy study released last month concluded that Treasury II would reduce electric utility tax liabilities by $4 billion a year. In the past decade, however, the industry never paid more than about $3 billion in a single year. Thus, it appears that Treasury II may reduce the electric utility industry's tax liability by more than that industry actually pays.

So instead of paying taxes, the utilities may actually receive annual refund checks from the IRS.

Under existing law, electric utilities are among the largest beneficiaries of Federal tax expenditures. The Treasury incurs about $12 billion in tax expenditures per year for electric utilities. This leaves the utilities with an effective tax rate of only about 7 percent. When a utility builds a powerplant, it can expect the Government to pay for at least 24 percent of the cost of that plant through tax subsidies. The largest source of these tax benefits is accelerated depreciation. And while Treasury II would cut back depreciation benefits for most industries, it would increase them for electric utilities.

Under Treasury II, the utility can depreciate a powerplant in just 10 years, even though these assets last typically for 30 to 50 years. The original Treasury I proposal would have depreciated powerplants over 38 years. This single change between Treasury I and Treasury II will cost the Treasury about $4 billion a year in lost revenues.

There is no need to offer such generous tax subsidies to utilities. They are regulated monopolies which are required to make the investments necessary to provide adequate service to their customers. Furthermore, utilities currently have record reserve margins and excess generating capacity.

In addition to increasing utilities' depreciation benefits, Treasury II would retain the provision which allows utilities to charge customers for billions of dollars in Federal income taxes which they aren't required to pay to the Government. Last year, major electric companies charged over $7 billion to customers for these so-called phantom taxes. For every dollar the utilities collected for income taxes from their customers, they actually paid only 30 cents to the IRS. The Nation's electric companies have accumulated over $41 billion in unpaid income taxes over the past 30 years. This is the equivalent of $486 for every household in the country.

A clause in the Federal Tax Code effectively prevents utility commissions from eliminating these tax overcharges. The 1969 law was intended to help finance construction of new generating facilities. Today, this provision contributes to the excess capacity that utilities have as well as wasted utility investments. It also discourages utilities from pursuing cost-effective energy saving measures.

It's inappropriate for the Federal Government to tie the hands of State utility regulators. The State regulators are better equipped than the Federal Tax Code to decide what investments are prudent and what sort of tax expense should be included in utility bills. But instead of resolving the phantom tax problem, Treasury II might actually create new sources of phantom taxes if Congress accepts the changes proposed by the utilities.

Senator Harkin has introduced a bill called the Electric Utility Tax Reform Act, S. 1457, which would give back to the States the right to regulate utilities' Federal income tax expenses. We encourage the Senate Finance Committee to incorporate this bill into its tax reform package.

Treasury II would also create a badly unbalanced energy tax policy, strongly favoring conventional energy sources like powerplants over alternatives like solar and energy conservation. While increasing depreciation for powerplants, Treasury II would actually cut depreciation benefits for alternative energy sources in half. It would also allow the special energy tax credits to expire at the end of this year. And that means canceling the Nation's best insurance policy against future energy shortages.

We applaud the administration's proposal to eliminate the investment credit, but we are concerned that Congress may adopt a generous transition rule which would let utilities and other businesses keep using investment credits for many years after their elimination. EEI has asked for an unlimited grandfather clause for the ITC. This would allow them to get the benefits of the lower tax rate without giving up existing tax benefits. And just to make sure that they don't have to pay income taxes under Treasury II, utilities have asked to modify the minimum tax.

Senator SYMMS. Can you try to summarize your statement?

Mr. MORGAN. Yes; I'm almost finished.

These proposals, we think, would make the minimum tax almost meaningless.

In conclusion, utilities would remain one of the Nation's most heavily subsidized industries under Treasury II. We estimate that as much as $10 billion may be at stake in these matters. We urge the Congress to consider whether such enormous tax expenditures are necessary for these regulated monopolies.

I'd like to thank the committee and the staff for allowing us the opportunity to present our views.

Thank you.

Senator SYMMS. Thank you, Mr. Morgan.

[The prepared written statement of Mr. Morgan follows:]

Environmental Action

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Testimony of
Richard E. Morgan

on behalf of
Environmental Action

before the
Senate Finance Committee

October 3, 1985

Statement of Richard E. Morgan
Environmental Action

Mr. Chairman and members of the committee, my name is Richard E. Morgan. I am an economist with the Energy Project of Environmental Action Foundation (EAF). I am testifying today on behalf of EAF's affiliate, Environmental Action.

My testimony concerns the impact of the Administration's "Treasury II" plan on electric utilities. Probably no other industry would be treated more favorably by the Administrations's plan than the electric utility industry. There is a strong possibility, in fact, that this industry may experience a negative income tax under Treasury II.

Despite Treasury II's generosity, the utilities have asked for at least 14 changes in the plan which would make it even more generous. We hope the Senate will not allow this tax plan to become a Christmas tree of new benefits for utilities. Instead, we urge the Senate to remove some of the costly and unnecessary benefits which Treasury II would offer to utilities.

Negative income tax. A Department of Energy study released last month concluded that Treasury II would reduce the electric utility industry's tax liability by approximately $4 billion per year. DOE estimated that the proposed changes in the tax code would reduce the level of utility industry tax liability from about $8 billion per year to about $4 billion.

In the past ten years, however, the utility industry has never paid more than $3.2 billion in federal income taxes in a single year. Unless there is a dramatic increase in the utility industry's profitability and tax liability, we should expect Treasury II to reduce the utility industry's tax liability by more than it currently pays. The result would be a negative income tax. Instead of paying taxes, utilities could receive refund checks from the Internal Revenue Service.

Already, at least 14 major electric companies pay a negative income tax under the current law. Under Treasury II, we can expect many if not most electric companies to receive an annual check from the IRS.

Existing federal tax expenditures for electric utilities. Electric utility companies are among the largest beneficiaries of federal tax expenditures under the current Internal Revenue Code. As the nation's most capital-intensive industry, the electric utilities make extensive use of tax benefits such as accelerated depreciation and investment tax credits. In 1983, electric companies paid an effective income tax rate of only 7.5 percent.

Edison Electric Institute (EEI), the utilities' trade association, has said that federal tax subsidies pay for 24 percent of the cost of each new power plant an electric company builds. Altogether, Environmental Action Foundation estimates that electric utilities benefit from over $12 billion in federal tax expenditures annually.

Depreciation benefits. While most industries would have their depreciation benefits cut back under President Reagan's "Treasury II" proposal, the plan would substantially increase write-offs for electric utilities. Treasury II would allow utilities to depreciate all power plants in just 10 years, even though such investments typically last 30 to 50 years. (The current law allows a generous 15-year write-off for coal-fired plants and just 10 years for nuclear plants.)

The original "Treasury I" proposal would have depreciated power plants over a 38-year period, reflecting their actual economic life. The change to a 10-year write-off would cost the Treasury $3.9 billion annually compared to Treasury I.

There is no need to offer such generous depreciation benefits to electric utilities. As regulated monopolies, utilities are already required to make the investments necessary to serve their customers, and they do not need further investment incentives. Moreover, most electric companies currently have substantial excess generating capacity and should not be encouraged to build more power plants. Write-offs for power plants should be at least 30 years to reflect their true economic life.

While encouraging utilities to build conventional power plants, Treasury II would discourage development of alternative energy sources such as solar and wind power. These decentralized energy technologies would have their write-off periods doubled from five to ten years under the plan.

Normalization accounting and "phantom" taxes. Treasury II would retain the provision in the present law which requires utilities to use "normalization" accounting for their investment tax credit (ITC) and accelerated cost recovery system (ACRS) benefits. This allows utilities to charge ratepayers for billions of dollars in federal income taxes which they are not required to pay currently to the IRS. These unpaid taxes are often referred to as "phantom" taxes.

According to a study by Environmental Action Foundation, the nation's major electric companies last year charged their customers $7.4 billion for federal income taxes they were not required to pay. For every dollar the utilities collect from ratepayers for federal income taxes, they actually pay only 30 cents to the IRS. Over the past 30 years, the nation's electric companies have accumulated $41.5 billion in unpaid income taxes which they have collected from ratepayers-- the equivalent of $486 for every household in the nation.

A clause in the federal tax code effectively prevents state utility commissioners from eliminating these tax overcharges. In fact, the law requires regulators to use an accounting method which allows utilities to earn extra profits on investments financed by tax funds provided by ratepayers.

When the law requiring utilities to collect phantom taxes was first passed in 1969, it was intended to help growing utilities finance the construction of new energy facilities. Today this law encourages utilities to overbuild and contributes to the industry's chronic problem of excess generating capacity. It also discourages utilities from pursuing cost-effective energy-saving measures.

In the past few years, utilities have abandoned unfinished power plants costing at least $20 billion, and the burden of these cancellations will be borne by the nation's ratepayers, taxpayers and utility shareholders. Without the financial incentives provided by the federal tax code, many of these projects might never have been started and this money could have been spent on other social purposes.

It is inappropriate and unnecessary for the federal government to tie the hands of state regulators by preventing them from determining the proper accounting method to be used for federal income tax expenses. State utility regulators are better equipped than the federal tax code to decide which utility investments are prudent and what income tax expense should be included in utility bills.

The Electric Utility Tax Reform Act of 1985 (S. 1457), introduced by Senator Tom Harkin, would provide state regulators with greater leeway to regulate their utilities' federal income tax expenses. We urge the Senate Finance Committee to incorporate the language of this bill into its tax reform package.

New sources of phantom taxes. Utility officials have proposed creative accounting treatment for two of the new tax benefits proposed in Treasury II, which would provide utilities with substantial new sources of "phantom" taxes. Edison Electric Institute has proposed that utilities be required to retain the benefits of the inflation adjustment component of Treasury II's CCRS depreciation system, rather than flow these benefits through to ratepayers. Similarly, the American Gas Association has proposed that utilities retain the benefits of the proposed 10-percent dividend deduction.

Unlike the ITC and ACRS benefits which must be normalized under current law, these new benefits would be permanent differences, not timing differences. Therefore, normalization would violate commonly accepted accounting principles. At the very least, the accounting treatment for these proposed new tax benefits should be left up to state utility regulators.

Congress should also consider whether there is any need to offer the proposed 10-percent dividend deduction to utilities. EEI has argued that this deduction would not benefit the shareholders of regulated utilities since regulators would be expected to flow this benefit through to ratepayers. By limiting this benefit to non-regulated businesses, Congress could enhance Treasury revenues by several hundred million dollars annually.

Retaining Investment Tax Credits. We applaud the Administration's proposal to eliminate the investment tax credit (ITC). We agree with the Treasury Department that this tax expenditure "encourages tax-motivated noneconomic behavior." We are concerned, however, that Congress may adopt a generous "transition rule" which would enable utilities and other businesses to continue using investment credits for years after this tax benefit expires.

Edison Electric Institute has asked for a transition rule which would enable businesses to retain ITCs indefinitely for any construction project with a binding commitment at the time the credit is eliminated. Since power plants can take 10 years or more to build, this provision could enable some utilities to continue claiming ITCs until the mid-1990s or later.

EEI has also proposed that businesses be allowed to retain unused ITCs to offset future tax liabilities after the ITC is eliminated. This could prove to be a large windfall for electric companies, which are holding billions of dollars worth of unused ITCs.

Because of their large capital expenditures, many utilities generate more ITCs in a given year than they use under the current tax code. Allowing businesses to continue using these old ITCs would defeat the purpose of eliminating the investment credit. Such a policy would perpetuate the injustices of the present tax code, favoring companies which have been most successful in taking advantage of the tax code in the past.

By extending the ITC in this way, Congress, in effect, would be permitting businesses to receive the reduced tax rates promised by Treasury II without giving up the benefits of the current law.

Keeping excess deferred taxes. The proposed change in the corporate tax rate from 46 percent to 33 percent would leave utilities with a substantial excess of deferred taxes which were collected under the old tax rate but would never be paid under the new tax rate. Some of these excess deferred taxes would be collected by the IRS under a "recapture" provision. Most of the excess deferred taxes (approximately $4 billion to $5 billion for electric utilities), however, would not be recaptured and would never be paid to the government.

Excess deferred taxes would remain on the utilities' books until state regulators order them refunded to ratepayers. In similar situations in the past, state utility commissions have typically ordered utilities to refund excess deferred taxes within a few years after the change in the tax rate.

EEI, however, has proposed that utilities be required to to keep any excess deferred taxes until they would have come due at IRS under the old tax rate-- a period of up to 30 years. There is no justification for allowing utilities to keep these excess deferred taxes for such a long period when they clearly do not represent a future tax liability. Congress' tax reform plan should expressly allow utility regulators to order refunds of excess deferred taxes which are no longer owed to the government.

Loopholes in the minimum tax. EEI has asked Congress to modify the Administration's "alternative minimum tax" in a way which would render this tax ineffective. The purpose of the minimum tax is to prevent corporate taxpayers from escaping all or most of their tax liability through excessive use of benefits available in the tax code. Treasury II would make businesses liable for a minimum tax at a reduced tax rate, but without taking into account benefits such as accelerated depreciation.

EEI, however, wants its alternative minimum tax to be calculated using the generous 10-year write-offs of the "capital cost recovery system" (CCRS) rather than the 38-year write-offs proposed in Treasury II. The utilities also want to use income averaging over a three-year period in calculating their minimum tax liability, and they want unused investment credits exempted from the tax. These proposed provisions, we believe, would make the minimum tax ineffective and meaningless.

Capitalization of construction-period interest. Treasury II proposes that businesses be required to capitalize the construction-period financing costs of new investments in personal property (such as power plants) instead of expensing them. (Investments in real estate are already required to capitalize interest costs in this way.) Edison Electric Institute has requested that only the debt portion of utility financing be included in calculating these interest costs. This seemingly minor change would cost the Treasury billions of dollars in revenues annually.

Energy tax credits. The inequities in the tax code's treatment of different energy technologies would be worsened by the elimination of the special energy tax credits under Treasury II. These tax credits for alternative energy technologies such as solar and wind help to balance the large subsidies available to conventional energy sources. If the government continues to offer tax incentives for conventional energy development, it must also provide incentives for saving energy and developing alternative energy sources. We therefore urge the Finance Committee to incorporate S.1220 into its tax reform legislation.

Conclusion. Under Treasury II, electric utilities would remain one of the nation's most heavily subsidized industries. As much as $10 billion in annual Treasury revenues may be at stake in the decisions made by Congress on electric utility tax issues addressed by Treasury II. Congress should consider whether such large tax expenditures are necessary, given this industry's status as a regulated monopoly.

STATEMENT OF AL NOFTZ, DIRECTOR OF TAXES, COMMONWEALTH EDISON, CHICAGO, IL; ON BEHALF OF EDISON ELECTRIC INSTITUTE

Senator SYMMS. Mr. Noftz.

Mr. NOFTZ. I'm Al Noftz, director of taxes for Commonwealth Edison Co. I'm substituting today for James O'Connor, chairman, president, and chief executive officer of Commonwealth Edison who regretfully could not be here today.

I appreciate the opportunity to represent the Edison Electric Institute, an association of electric companies. Its members generate approximately 75 percent of all electricity in the country; we provide electric service to 73 percent of the Nation's electric consumers.

The portion of the President's proposal dealing with employee benefits is of major concern to our industry, and its employees. We have submitted a separate statement for the record detailing them, and have dealt with them at length in our written testimony.

And I certainly should like to express our appreciation for your chairman's efforts in this critical area of importance to our employees.

Today, I shall focus primarily on the President's proposals now before the committee, but in addition I shall make some observations on the joint committee staff options being considered by the House Ways and Means Committee.

As Mr. Foley said, the Edison Electric Institute has supported the President's tax reform and it is based on two conditions. But those conditions would not result in any distortions.

One of the conditions is that the proposed capital cost recovery system, including normalization, be retained in substantially its present form. And, two, that reasonable transition rules be adopted if the investment credit is repealed. Those conditions were established because the electric utility industry is among the most capital intensive, and our need for capital to meet consumers' needs is expected to continue to grow.

Without retention of a capital formation incentive system, substantially similar to the capital cost recovery system, and an equitable phasing out of the investment credit, the President's tax reform proposal would be so detrimental to electric utilities and to our customers that we no longer could support the President's tax reform package.

One of the basic objectives of tax reform is the neutral treatment of investment. Historically, the electric utility industry's investments have been taxed at a higher rate than other industries. Under the President's proposal neutral investment incentives are provided by setting depreciation rates and recovery periods to produce an 18-percent tax rate on the income from new investments in all types of machinery and equipment.

A recent study made for EE indicates that new utility property placed in class 5 under CCRS would be taxed at about 22 to 24 percent. Although this exceeds the administration's intended 18 percent rate, the bias against electric utility property would be less than under current law.

Even with the placement of most utility property in class 5, the capital cost recovery system would not provide capital equal to that of the combination of ACRS under current law and the investment credit. Therefore, if the present inclusion of electric utility property in class 5 were to be changed to a longer recovery period, our industry would be even more severely disadvantaged and the playing field would become so unleveled that we could not support the President's proposal.

In this regard, the staff option on depreciation for the Ways and Means Committee is substantially different from the President's proposed depreciation system. The staff option abandons the objective of neutral investment incentive. It provides for much longer lives for electric utility property. It provides accelerated depreciation that is much slower and it does not provide for the indexing of depreciable property for inflation. Consequently, it would be less beneficial to our customers. We, therefore, strongly urge this committee to adopt the President's CCRS system as proposed.

Turning to the investment credit—if it is to be repealed, several apsects must be addressed. Our major concerns center on three matters. One, the absence of transition provisions. Two, the regulatory treatment of unamortized credits. And, three, the ability to carry forward credits unused as of the repeal date. There is precedent for equitable transition treatment. In 1969 when the credit was repealed, it continued to be available for taxpayers that were bound by contract, but that had begun construction by April 18, 1969.

Under the transition rules, credits would not have been available for property placed in service after December 31, 1985. Substantially similar rules were adopted when the credit was suspended in 1966. Assuming an approach substantially similar to that followed in 1969, an October 1985 date could be substituted for April 18, 1969. And other dates could be established that would be comparable to the 1969 legislation.

Moreover, under any circumstances, qualified progress expenditures made through the end of a transition period should remain eligible for the credit, and the credits claimed on them should not be subject to recapture solely because the asset was not placed in service by that date.

I would also like to discuss the corporate alternative minimum tax, if I may have another minute.

Senator SYMMS. Go ahead.

Mr. NOFTZ. It appears to be a very reasonable concept to ensure that all taxpayers pay their fair share of tax. However, a number of electric utility companies in recent years have been unable to utilize all of their investment credits due to adverse financial conditions. Investment decisions were made with an understanding that credits would be available to offset tax. To deny the application of credits against the minimum tax may be said to violate a compact that the Government has with those who made such decisions.

If there is to be an alternative minimum tax, we urge that it not be at a rate higher than that set by the President's proposals and that it not be anything that would destroy the capital incentive formation provisions that are in the President's proposal.

Thank you.

Senator SYMMS. Thank you very much, Mr. Noftz.

[The prepared written statement of Mr. James J. O'Connor follows:]

STATEMENT OF

JAMES J. O'CONNOR

CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

COMMONWEALTH EDISON COMPANY

ON BEHALF OF

THE EDISON ELECTRIC INSTITUTE

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

October 3, 1985

Mr. Chairman and Members of the Committee:

I am James J. O'Connor, Chairman, President and Chief Executive Officer of Commonwealth Edison Company. I appreciate the opportunity to appear before you today representing the Edison Electric Institute (EEI) to present our views on the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.

EEI is the association of electric companies, and its members serve 96 percent of all customers served by the investor-owned segment of the industry. They generate approximately 75 percent of all electricity in the country and provide electric service to 73 percent of the nation's consumers.

INTRODUCTION

EEI supports reform and simplification of the Internal Revenue Code (Code) to achieve fair and equitable individual and corporate taxation. However, it is important that our system of taxation continue to encourage economic growth. We therefore also support the objectives of the President's proposals that would retain capital-formation incentives, which are critical to the electric utility industry. The capital formation incentives contained in the Code, such as the investment tax credit and accelerated depreciation, provide a substantial portion of the capital needed for electric utility construction.

Of the President's proposals, the repeal of the investment tax credit, the elimination of tax-exempt financing for private purposes and the expiration of tax-deferred dividend reinvestment would have significant detrimental effects on capital formation for utilities. Although the overall effect of the President's proposals on our companies will be adverse because of our capital intensive nature, the effect of these proposals on electricity customers generally is beneficial. Therefore, we support this tax reform package if the proposed Capital Cost Recovery System (CCRS), including normalization, is retained in substantially its present form and if reasonable transition rules are adopted for any repeal of the investment tax credit. In this latter regard, we are pleased, Mr. Chairman, that you, Chairman Rostenkowski and Secretary Baker have agreed to develop appropriate "grandfather" and transition rules for the investment tax credit.

The electric utility industry is one of the most capital intensive in the United States. On average, electric utilities need $2.74 of capital investment for every dollar of sales whereas most other U.S. industries need less than $1.00 of capital investment for every dollar of sales. Since 1982, the trend has been to reduce the capital-formation incentives included in the Code. Unfortunately, the President's proposals would continue this trend.

Despite the views expressed by some that electric utilities have surplus electric-generating capacity, we would urge this

Committee to keep in mind that by 1993, using a moderate rate of growth in the demand for electricity of 2.5 percent annually, this country will have a need for a 28-percent increase in new generating capacity. To put this in perspective, this is about seven-and-a-half times the projected summer peak load for the State of New York for 1985. Further, capital requirements also arise from the need for transmission and distribution facilities, which soon will constitute about 40 percent of the industry's construction expenditures.

This clearly demonstrates that utilities must build to meet the demands placed upon the industry by their customers. Although conservation, load management, and the development of renewable energy resources have helped to reduce these demands, they are not sufficient to forgo construction of new electric-generating capacity. If we as a nation were to experience gaps in the reliability of our electricity supply, the result would be a severe blow to our economic growth, with subsequent loss of jobs and income, and a weakening of the nation's competitive position in the world economy. For these reasons, it is critical that the Code have capital-formation incentives.

Set forth below are specific recommendations regarding certain aspects of the President's proposal that we urge the Committee to adopt.

CAPITAL-FORMATION INCENTIVES

CCRS

EEI supports the concept in CCRS of neutral investment incentives for equipment of all industries. This concept is consistent with the theme in the President's tax reform package that a "level playing field" is intended for investments of all taxpayers. In the past, electric utility property too often has been singled out for disproportionately long recovery periods. This longstanding, unjustified disparity presumably would be corrected under CCRS as proposed.

As former Assistant Secretary of the Treasury for Economic Policy Paul Craig Roberts stated before this Committee on June 27, "[r]egulated public utilities would receive a long overdue redress of the discrimination shown over the past decades in the tax law. This industry has repeatedly been assigned longer tax lives for the same assets owned by other industries. The administration's proposal corrects this, and utility assets are conformed to all other industries."

Under CCRS, all depreciable assets would be categorized in one of six classes, with assets in each class having similar economic depreciation periods. A level playing field would be more nearly created by providing equal economic treatment for all property in classes one through five. According to the President's proposal, neutral investment incentives are provided by setting depreciation rates and recovery periods to produce a rate of taxation of 18 percent on the income from new investments in all types of machinery and equipment. In fact, however, based on a recent study made for EEI, the cash flow from investment in new utility property placed in class 5 under CCRS would be taxed at about 22 to 24 percent. Although this exceeds the Administration's intended 18 percent, the bias is less than that which existed in prior years. A copy of this study is attached for the Committee's consideration.

Some critics of the inclusion of utility property in class 5 within CCRS have suggested we are receiving too generous treatment under CCRS. However, as stated earlier, we have, in fact, been in an historically disadvantaged position with regard to the depreciable lives of utility property. The fact that we are from 4%-6% above the Administration's intended 18% tax rate within class 5 rebuts arguments that utility property is receiving too advantageous treatment under CCRS.

As explained in the President's proposal, the recognition of inflation by indexing capital assets is also essential to attain economic neutrality. We commend this approach. The electric utility industry nevertheless would pay a high price under the President's proposals because CCRS would not provide capital equal to that of the combination of ACRS and the investment tax credit. Therefore, if the present inclusion of electric utility property in class five under CCRS were to be changed to inclusion in a class with a longer recovery period, our industry would be even more severely disadvantaged, and the playing field would become so "unleveled" that we could not support the President's proposal.

With respect to the proposed establishment of a permanent government office to conduct empirical studies of economic depreciation for the purpose of adjusting recovery periods under CCRS, we submit that such an office would foster additional complexity in the depreciation system, would create another bureaucratic level in tax matters and would significantly increase the uncertainties that affect investment decisions. Reclassifications of property under CCRS should not be left to administrative action; instead, only the Congress should be able to establish new CCRS classes or to reclassify property from one class to another.

Normalization of Depreciation

The benefits to the electric utility industry under CCRS would contribute to capital formation only if such benefits are normalized consistent with rules in existing law and in the President's proposals. Normalization allows electric utilities to compete on a more level playing field with other providers of energy and in the capital markets. Normalization therefore should be treated as part of the concept of investment neutrality.

We are pleased that the President recognizes the need for normalization provisions similar to those in present law. Regulated companies should be required to normalize the tax effect of the timing differences between CCRS depreciation without inflation adjustments and straight-line depreciation of the tax basis of property using lives prescribed for financial-accounting and ratemaking purposes. If a regulated company were to violate the normalization requirement, then it should not be permitted to use CCRS depreciation. Normalization would assure a sharing of the benefits of CCRS between a utility's present customers and its future customers.

Further, regulated companies also should be required to normalize the tax effect of depreciation differences that would be attributable to CCRS inflation adjustments, because depreciation of inflation adjustments is designed to provide a pool of capital to make higher-cost future investments. According to the President's proposal, inflation indexing can also be thought of as supplanting, in part, the investment tax credit. Appropriately, therefore, the effect of depreciation of inflation adjustments should be required to be ratably flowed back by regulated companies over the life of the related asset in a manner similar to the treatment prescribed under current law for regulated companies for the investment tax credit. This would result in a sharing of the benefit of the depreciation inflation adjustment between a utility's shareholders and its customers. The sanction for violation by a regulated company of these normalization rules could be the loss of the benefit of depreciation of the CCRS inflation adjustment.

Under the theory expressed in the President's proposal, the tax that would be imposed in 1986, 1987, and 1988 on benefits attributable to so-called excess depreciation constitutes a payment of taxes previously deferred. Thus, if this provision were enacted, the payment of such taxes should be charged to existing applicable deferred income tax reserves, and final legislation should specifically require such treatment for regulated companies which should not be considered to violate normalization requirements.

Because of the magnitude of the proposed decrease in the tax rate to 33 percent, appropriate rules should be provided for regulated companies in any legislation enacted to prescribe the treatment to be afforded deferred taxes that have been accumulated at higher tax rates. We recommend that use of the "average rate assumption method" be mandated for the purpose of returning any "surplus" of deferred income taxes to a utility's customers. The average rate assumption method generally is employed by many companies for financial- and regulatory-accounting purposes to flow back deferred taxes as timing differences reverse. Under this method, as timing differences reverse, the normalization provision is developed by multiplying the timing difference by the weighted average tax rate at which the deferred taxes were entered into the reserve.

Investment Tax Credit

The repeal of the investment tax credit would be particularly detrimental to the electric utility industry. The credit has provided an important source of capital to help finance the construction of needed electric-generating facilities and transmission and distribution facilities. A loss of the credit would require significant increases in external financing.

If the investment tax credit were to be repealed, several aspects related to the repeal need to be addressed. Our major concerns are the absence of transition provisions, the regulatory treatment of unamortized investment tax credits, and the ability to utilize credits unused as of December 31, 1985.

As drafted, the proposal would repeal the investment tax credit for any property placed in service on or after January 1, 1986. However, the President anticipates that Congress will provide reasonable and appropriate transition rules with respect to the investment tax credit. Of course, transition rules would be necessary because to change the rules in mid-stream would be unfair and would result in the elimination of a substantial source of financing for multi-billion dollar projects that were initiated, and for which funds have been committed, in reliance on current law.

There is precedent for appropriate transition treatment. When the investment tax credit was repealed in 1969, the repeal generally was effective for property for which physical construction began after April 18, 1969, or property that was acquired after April 18, 1969. Where a taxpayer was bound by contract on April 18, 1969, and at all times thereafter, to acquire property or to have it constructed, the investment tax credit was available for such property. An "equipped building rule," a "plant facility rule," a "machinery or equipment rule" and other exceptions were provided to protect credits of taxpayers who had made investment decisions based on the availability of the investment tax credit. In any case, under the transition rules, credits would not have been available for property placed in service after December 31, 1975. Substantially similar transition rules were adopted when the investment tax credit was suspended in 1966.

Relative to the proposed repeal of the investment tax credit, which would be effective January 1, 1986, and assuming an approach substantially comparable to that followed in 1969, an October, 1985 date (date of House Committee action) could be substituted for April 18, 1969. Other dates could be established that would be comparable to the 1969 legislation. For example, property qualifying for the credit would have to be placed in service prior to a date about six years in the future, such as prior to January 1, 1992.

In addition, because the investment tax credit was not available on qualified progress expenditures in 1969, that matter was not addressed in the 1969 legislation, but should be addressed now if the credit is repealed. A transition rule should provide that credits on qualified progress expenditures that (i) meet the exceptions stated above and (ii) are incurred prior to 1992 can be used to reduce taxes and will not be subject to recapture upon repeal even though the related property is placed in service after 1991.

If the investment tax credit were repealed, there should be a continuing normalization requirement for the credits of regulated companies. There should be a penalty for any violation of the terms under which the credit was initially permitted. The penalty should be sufficiently severe to be a deterrent to such violations. As a sanction for violations occurring after 1985, a recapture tax could be established measured by the greater of (i) the investment tax credit generated by the subject utility for all open taxable years, or (ii) the balance of the utility's unamortized investment tax credit as of the close of the taxable year immediately preceding the taxable year during which the normalization rules were violated.

The continued sharing of investment tax credits between customers and shareholders of electric utilities is an important aspect of the financial health of many EEI member companies and would reflect the intent of Congress in enacting the investment tax credit by preventing it from becoming a short-term subsidy for the users of electricity.

The President's proposal is silent with respect to the future availability of the carryover of unused investment tax credits that arose under present or prior law. It should be made clear that these carryovers, unreduced for a lower tax rate, will remain available for use in future years to avoid undue hardship on those taxpayers most in need of the financial assistance provided by the investment tax credit.

EMPLOYEE BENEFITS

As you know, EEI has submitted a separate statement for the record on the subject of employee benefits, which details our position on the President's proposals. Before summarizing our concerns in this area, we would like to express our appreciation to you, Mr. Chairman, for your efforts in this area of critical importance to our employees.

Overall Comment

During the last few years, so many changes have been enacted in the area of retirement and other employee benefit plans that there is much confusion on the part of employees, employers, and the Internal Revenue Service as to what actually is required for plans today. Another wholesale revamping of such plans, as would be necessary under the President's proposal, would, of course, create even more confusion. More importantly, employees have been making investment, savings, and retirement decisions over their working careers based on prior and current law. To change them now, as extensively as the President proposes, would be both unfair and harmful to the employees who, in good faith, made those decisions based upon the provisions in the Code at the time.

Section 401(k) Plans

Our industry, like most others in the United States, has established employee benefit plans as a supplement to direct compensation to help our employees plan for their retirement security. These benefit plans were established in good faith in accordance with the provisions of the Code and other rulings from the Internal Revenue Service. Since 1982, three major pieces of legislation have disrupted the stability of the private sector system of employee benefits, and have, in some respects, begun to erode the foundation of the private pension system. Now, the President's recent proposal to repeal the provisions in the Code authorizing cash or deferred arrangements, commonly called section 401(k) plans, poses a further threat to this important private sector mechanism of providing security to our employees, with the potential result of an increased demand on the government for retirement benefits.

According to one leading employee benefit research organization, 29 percent of Americans do not set aside any savings for their retirement other than benefits provided by their employer. Employer-sponsored qualified retirement savings plans have provided most of the incentive that does exist for individual savings in this country. In our own industry, we have seen a dramatic increase in employee participation in retirement savings plans over the past few years.

If the proposed repeal of 401(k) plans were enacted, employees who can no longer participate in such a company-sponsored retirement savings plan may not set aside adequate savings for retirement through other vehicles. As a result, these persons could depend more upon the federal government at retirement age for increased social security benefits or other government-sponsored programs. Sound national policy should encourage employees to save for retirement, not discourage it, and we therefore believe this proposal should not be enacted.

Employees have been making investment, savings, and retirement planning decisions over their working careers based upon the assumptions that existing laws would be in effect. To again change these laws would be unfair to employees and would make it extremely difficult for them to adequately plan for their security after retirement. Further, any proposals to change the laws governing employee benefits should be considered within the context of the potentially damaging effect that such changes could have on the private sector's system of employee benefits that has worked so well over the past several decades.

Annual Contribution Cap

As an alternative to repeal, if the Committee should consider an annual cap on the amount of an employee's contribution to a 401(k) plan, any such cap should be expressed as a percentage of income. Further, the inclusion of IRA contributions in arriving at a cap would be unworkable when applied at the employer level.

Early Withdrawal Penalties

Excise tax penalties on benefits paid under qualified retirement plans prior to attaining age 59-1/2 in many instances would deter employees from retiring at an earlier age even though they are permitted to under the rules of their retirement plan. Equity dictates that excise taxes not apply to any payment from a qualified plan by reason of retirement at any age because to preclude an employee from retiring by means of an excise-tax penalty takes away the employee's right to determine his or her own retirement date.

Lump-Sum Distributions

Ten-year averaging for lump-sum distributions from qualified plans provides a vital means for a majority of employees to make their own decision as to how they want to use the savings that they accumulated during their working career. Higher-paid employees, for the most part, will utilize a rollover to an IRA, but ten-year averaging still should be permitted for distributions to more modestly paid employees. If ten-year averaging were repealed, then amounts allocated to employees prior to the enactment of the repeal should be "grandfathered."

Employer-Provided Health-Care Benefits

The existence of employer-provided health-care benefits is an example of a privately sponsored program that decreases the dependence upon governmental assistance for providing health care. We believe that imposition of the income tax on employer-provided health-care benefits would set a dangerous precedent and could discourage employees from participating in such programs. Many employees might drop out of employer-sponsored medical programs, which could place the burden of providing their health-care benefits on programs funded by the government. This would not be in the best interest of either employees or the government.

OTHER CAPITAL RECOVERY CONCERNS AND RECOMMENDATIONS

EEI is pleased that each CCRS class would be assigned a safe-harbor repair allowance factor to permit expenditures incurred after an asset is placed in service to be deducted provided that a prescribed limitation is not exceeded. In the past, the repair allowance has reduced controversies with the Internal Revenue Service that many taxpayers had experienced in determining allowable repair deductions. Present law provides for an election of the repair allowance by class of property rather than an asset-by-asset election, which would seem to be provided under the President's proposal. For the sake of simplicity, continuity, and administrative ease, we recommend that the concept of an election of the repair allowance by class of property be retained.

Under CCRS, the first-year depreciation rate would be prorated based upon the number of months an asset is in service. Because of the number and nature of assets that an electric utility places in service each year, the monthly-averaging convention would be an administrative nightmare and would add unnecessary complexity and expense in implementing the tax law. We strongly urge the adoption of a mid-year, first-year averaging convention under CCRS, similar to the convention used in other depreciation systems under the Code.

Adoption of CCRS would mean that many businesses would have many systems of depreciation for their assets, such as facts and circumstances, the class life system (CLS), the class life asset depreciation range system (CLADR), the accelerated cost recovery system (ACRS), modifications of these systems for various purposes, such as for earnings and profits, and CCRS. Having to administer that many capital recovery systems under the tax law is a severe administrative burden. The burdens on taxpayers should not be compounded by requiring the implementation and maintenance of yet another system, the real cost recovery system (RCRS), which merely was proposed, as part of the November 1984 Treasury tax reform proposal, and then withdrawn. Under the President's proposal, RCRS would have to be maintained for such purposes as arriving at earnings and profits and tax preference amounts for the alternative minimum tax. Instead, we recommend that CCRS be used for such purposes, but with the earnings-and-profits lives now in effect as part of ACRS.

We also recommend that taxpayers be permitted to elect the use of a unit-of-production method of depreciation with applicable inflation adjustments rather than CCRS for any asset or any class of assets that are appropriately depreciated under a method not expressed in terms of years. The unit-of-production method of depreciation is permitted under other depreciation systems under the Code.

EXCESS DEPRECIATION

Because it would establish a dangerous precedent of retroactively adjusting prior years' tax deductions, the electric utility industry is concerned with the proposal that would have the effect of denying benefits from a reduction in the income tax rate that are attributable to what is termed to be "excess depreciation" from prior years. Neither an electric utility nor its shareholders would receive windfall benefits from prior years' deductions.

Under existing regulatory procedures, we would expect benefits from a reduction in the income tax rate to be passed through to customers in the form of lower rates for electricity. Therefore, we believe that the provision for taxing excess depreciation should not be enacted.

However, if such a provision were enacted, the computation for determining the amount of excess depreciation should be based upon the tax lives of the assets rather than the earnings-and-profits lives as provided in the proposal. It was the primary intent of the President's proposal to deny a windfall tax rate benefit to those taxpayers who depreciated their assets using accelerated versus straight-line depreciation methods. An inequity occurs from using the earnings-and-profits lives. This inequity can be demonstrated by the fact that a short-lived asset, such as five-year ACRS property which was placed in service in 1981, would be fully depreciated in 1986 before the tax rates change. Yet windfall tax rate recapture would be imputed for such an asset even though a rate reduction benefit had not occurred. This problem results because the President's proposal utilizes the earnings and profits life which for a five-year ACRS asset is 12 years. This occurs in regard to all ACRS asset additions and can be rectified by utilizing the tax life of the asset as opposed to the earnings-and-profits life. In no event should payment of the tax occur over a period shorter than the remaining lives of these assets or ten years.

CAPITALIZATION OF CONSTRUCTION-PERIOD INTEREST

EEI is concerned that construction-period interest and other construction overhead costs would have to be capitalized under the President's proposal. As proposed, "construction-period interest" would be defined to include any interest expense of a taxpayer that could be avoided if the funds for construction expenditures, instead, were used to repay indebtedness. This necessarily assumes that 100 percent of construction is financed by means of borrowed funds. While this assumption may or may not be true with respect to nonregulated businesses, it can be stated without equivocation that this is not true for regulated electric utilities.

The regulatory accounting rules of many jurisdictions already require full or partial capitalization of financing costs on projects involving significant construction periods or costs. These rules recognize that both debt and equity capital are used in the financing of construction of facilities by regulated companies. This method of capitalizing financing costs generally is referred to as an "allowance for funds used during construction" (AFUDC). If any changes regarding interest capitalization are enacted, we recommend that, at least for regulated utilities, only the debt component of AFUDC be required to be capitalized.

EEI also recommends that certain other rules similar to those prescribed by regulators be included in any legislation that would require the capitalization of interest. Such rules should recognize that it would be unnecessarily burdensome to require the capitalization of interest on projects of less than a prescribed dollar amount or of those with a short construction period.

ALTERNATIVE MINIMUM TAX

The President's proposal to enact an alternative corporate minimum tax appears to be a reasonable attempt to ensure that all taxpayers pay their fair share of tax. However, if fairness is to be achieved, we have several specific concerns that deserve further consideration.

There are a number of electric utility companies that in recent years have been unable to utilize all of their investment tax credits and now have unused credits, which, under current law, can be carried over to be used in 1986 and later years to reduce income tax liabilities. The proposed alternative minimum tax would unfairly penalize these companies, because investment credits would not be allowed to reduce the alternative minimum tax and effectively would be treated as a tax preference item. To treat a benefit intended to have been realized in prior years as a current tax preference item would be unfair and would impose a severe penalty on affected taxpayers. Therefore, if an alternative minimum tax is enacted, the legislation should provide that investment tax credits can be utilized as a credit against the alternative minimum tax, thereby allowing investment tax credits to be used without penalty.

Furthermore, many utility taxpayers experience significant fluctuations in taxable income from year to year. Many such fluctuations are caused by the mechanics of the ratemaking process. For this reason, any alternative corporate minimum tax computation should be based upon a comparison of the regular income tax liability for a base period of not fewer than three years (the current year and the prior two years). The alternative minimum tax for any year should only be applicable if it exceeds such average regular income tax liability for the base period.

With respect to the 25-percent interest-expense tax preference item, to achieve fairness, only incremental debt incurred after the date of adoption of an alternative minimum tax should be part of the tax preference computation. Finally, the list of tax preference items under the proposed alternative minimum tax should not be expanded beyond those included in the President's proposal.

TEN-PERCENT DIVIDENDS-PAID DEDUCTION

While we are pleased that the President's proposals recognize the need to alleviate the multiple taxation of corporate earnings by providing a deduction to corporations equal to ten percent of dividends paid, we believe a more effective approach would be to provide a dividends-received deduction or credit at the shareholder level.

The analysis which accompanies the President's proposals observes that the dividends-paid deduction would be of greater benefit to industries and firms that distribute a large part of their earnings as dividends. It specifically recognizes the electric utility industry as one that would derive relatively greater benefits from this deduction. While it is true that the electric utility industry pays out a relatively large percentage of its earnings as dividends, it does not follow that our shareholders would benefit from this deduction or that the deduction would result in any increase in the flow of investment capital to electric utilities.

We cannot predict the effect this deduction would have on non-regulated corporations; i.e., whether it would benefit their shareholders or be reflected in lower prices for their products or services. However, for the electric utility industry, it is reasonable to assume that regulators would use the reduced income tax liability resulting from the dividends-paid deduction to lower rates for electric service by allocating the benefits to customers and not to shareholders. In other words, it simply would not accomplish its stated purpose. We believe that, instead, a deduction or credit at the shareholder level would be a more effective step toward the elimination of the multiple taxation of corporate earnings and would help the flow of investment capital to our industry.

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Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or members of the Committee might have.

Depreciation of Electric Utility Property

The proposed depreciation system contained in the President's tax reform proposal referred to as the Capital Cost Recovery System (CCRS) attempts to provide a neutral investment incentive on all depreciable property. Accordingly, CCRS depreciation rates and recovery periods have been set so that the effective tax rate on most property and equipment over its useful life will be 18 percent. To obtain this result, the Treasury Department placed utility property in Class 5.

Some critics charge that this depreciation system is too favorable to electric utilities. Historically in fact, depreciation schedules have been biased against utility property though there is no economic justification for this. Because utility property was disadvantaged in the past, this move to a neutral depreciation system makes the property appear to receive more generous treatment.

To analyze the Administration's placement of utility property in Class 5, the attached study was prepared by Emil Sunley of Deloitte, Haskins and Sells * to determine the effective tax rate for utility property under CCRS. In fact, the study revealed that utility property in this class will have an effective tax rate of 21.8 percent or higher, depending on the after-tax rate of return assumed, thus exceeding the Administration's target.

The model employed took into account that a utility's revenue requirements are set by regulators to achieve an allowed, after-tax, rate of return on investments. The model also used the following assumptions to determine the effective tax rate:

- Straight-line depreciation over 30 years is used.
- Normalization of depreciation is required as in the tax proposal.
- The assumed rate of inflation is 5 percent which is the same rate used by Treasury.

Using Treasury's assumptions of a 4 percent real after-tax rate of return, the effective tax rate on utility property would be 21.8 percent. If these rates of return on rate base increase, the effective tax rate also increases as the table below points out.

Utility Property Effective Tax Rate Under CCRS

Case	After-tax** Return on Rate Base	Computed Real Rate of Return	Real Effective Tax Rate
1	9.2%	4.0%	21.8%
2	10.0%	4.8%	22.3%
3	14.0%	8.6%	24.2%

From these calculations, it is clear that the placement of utility property in Class 5 is not only justified but actually falls short of the intended neutrality that Treasury was attempting to achieve. If utility property were moved to another class with longer depreciation lives, once again it would be even more severely disadvantaged. It should be kept in mind that utilities must compete in the same capital markets as all other industries and should not be treated any differently under these tax provisions which stimulate investment. If they are, it is customers who ultimately bear the burden of more costly machinery and equipment which is ultimately reflected in their electric bills.

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* Emil M. Sunley, Director of Tax Analysis in the National Affairs Office at Deloitte, Haskins & Sells, was Deputy Assistant Secretary of Treasury for Tax Policy, 1977-1981.

** The after-tax return on rate base is equal to the real return, times the inflation rate. For example, the 4.0% real rate of return is combined with the assumed inflation rate of 5% to equal a 9.2% after-tax return on rate base (1.04 x 1.05 = 9.2.)

CASE 1

ECONOMIC ASSUMPTIONS	
Inflation Rate	5.0%
First Year Use %	50.0%
REGULATORY ASSUMPTIONS	
Return on Rate Base	9.2%
Regulatory Useful Life	30
TAX ASSUMPTIONS	
Federal Tax Rate	33.0%
Declining Balance %	175%
Recovery Period	10

CALCULATED RESULTS:	
Nominal Return Before Tax	10.37%
Real Return Before Tax	5.12%
Nominal Return After Tax	9.20%
Real Return After Tax	4.00%
Nominal Effective Tax Rate	11.30%
Real Effective Tax Rate	21.07%

LINE & ITEM	HOW DERIVED	AMOUNTS Year: 1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21
2 Cash Invested	Data	100.0																				
3 Inflation Factor	Based on Inflation Rate	1.000	1.050	1.103	1.158	1.216	1.276	1.340	1.407	1.477	1.551	1.629	1.710	1.796	1.886	1.980	2.079	2.183	2.292	2.407	2.527	2.653
CCRS DEPRECIATION																						
4 Years Remaining	Based on Recovery Period	10.0	9.5	8.5	7.5	6.5	5.5	4.5	3.5	2.5	1.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
5 Straight-Line Fraction	1/(Line 04)	10.0%	10.5%	11.8%	13.3%	15.4%	18.2%	22.2%	28.6%	40.0%	66.7%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
6 Depreciation Factor	Greater of DB% and Line 05	8.5%	17.0%	17.0%	17.0%	17.0%	18.2%	22.2%	28.6%	40.0%	66.7%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
7 Balance at Start	Previous Line 07 minus 08	100.0%	91.5%	75.9%	63.0%	52.3%	43.4%	35.5%	27.6%	19.7%	11.8%	3.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
8 Depreciation Coefficient	Line 06 times Line 07	8.5%	15.6%	12.9%	10.7%	8.9%	7.9%	7.9%	7.9%	7.9%	7.9%	3.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9 Inflation Adjusted Base	Init. Investment times 03 times 07	100.0	96.1	83.7	73.0	63.6	55.4	47.6	38.9	29.2	18.4	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10 CCRS Depreciation	Line 06 times Line 09	8.5	16.3	14.2	12.4	10.8	10.1	10.6	11.1	11.7	12.2	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Difference	Line 09 minus Line 010	91.5	79.7	69.5	60.6	52.8	45.3	37.0	27.8	17.5	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RATE BASE & REVENUE REQUIREMENT																						
12 Years Left	Based on Regulatory Useful Life	30.0	29.5	28.5	27.5	26.5	25.5	24.5	23.5	22.5	21.5	20.5	19.5	18.5	17.5	16.5	15.5	14.5	13.5	12.5	11.5	10.5
13 Net Depreciable Assets	Previous 013 minus Previous 014	100.0	98.3	95.0	91.7	88.3	85.0	81.7	78.3	75.0	71.7	68.3	65.0	61.7	58.3	55.0	51.7	48.3	45.0	41.7	38.3	35.0
14 Rate Base Depreciation	Line 013 divided by Line 012	1.7	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
14.1 Unamortized Bal. CCRS Inf. Adj.	Prev.(014.1 minus 014.2 plus 026.3)	0.0	0.0	0.3	0.7	1.2	1.8	2.5	3.2	4.2	5.2	6.4	6.9	6.6	6.2	5.9	5.5	5.1	4.8	4.4	4.1	3.7
14.2 Amortization CCRS Inf. Adj.	Line 014.1 divided by Line 012	0.0	0.0	0.01	0.02	0.05	0.1	0.1	0.1	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
15 Deferred Tax at Start	Previous Line 028		2.3	6.3	9.4	11.9	13.7	15.2	16.7	18.2	19.7	21.2	21.5	20.4	19.3	18.2	17.1	16.0	14.8	13.7	12.6	11.5
16 Net Rate Base at Start	Line 013 minus 014.1 minus 015	100.0	96.1	88.5	81.5	75.2	69.5	64.0	58.4	52.6	46.7	40.7	36.6	34.8	32.9	31.0	29.1	27.2	25.4	23.5	21.6	19.7
17 Return on Rate Base	Rate of Return times Line 016		8.8	8.1	7.5	6.9	6.6	5.9	5.4	4.8	4.3	3.7	3.4	3.2	3.0	2.9	2.7	2.5	2.3	2.2	2.0	1.8
18 CCRS Depreciation	Line 010	8.5	16.3	14.2	12.4	10.8	10.1	10.6	11.1	11.7	12.2	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
19 CCRS if Historical Cost	$100.0 times Line 08	8.5	15.6	12.9	10.7	8.9	7.9	7.9	7.9	7.9	7.9	3.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
21 CCRS Inflation Adjustment	Line 018 minus Line 019	0.0	0.8	1.3	1.7	1.9	2.2	2.7	3.2	3.8	4.4	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
22 Income Tax Allowance Base	Line 017 minus 014.2	0.0	8.8	8.1	7.5	6.9	6.3	5.8	5.2	4.7	4.1	3.4	3.0	2.8	2.7	2.5	2.3	2.2	2.0	1.8	1.6	1.5
23 Income Tax Allowance	Line 022 times [33%/(100%-33%)]	0.0	4.4	4.0	3.7	3.4	3.1	2.9	2.6	2.3	2.0	1.7	1.5	1.4	1.3	1.2	1.1	1.1	1.0	0.9	0.8	0.7
24 Total Revenue Requirement	Sum of 014, 017 & 023, minus 014.2	1.7	16.5	15.3	14.5	13.6	12.8	12.0	11.1	10.3	9.4	8.5	7.8	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5
25 Taxable Income	Line 024 minus 018	-6.8	0.2	1.2	2.1	2.8	2.7	1.4	.0	-1.4	-2.9	2.0	7.8	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5
26 Income Tax Paid	33% of Line 025	-2.3	0.1	0.4	0.7	0.9	0.9	0.5	.0	-0.5	-0.9	0.7	2.6	2.5	2.4	2.3	2.2	2.2	2.1	2.0	1.9	1.8
26.1 Tax.Inc. w/o CCRS Inf.Adj.	Line 025 plus Line 021	-6.8	1.0	2.6	3.8	4.7	4.9	4.1	3.2	2.4	1.5	4.5	7.8	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5
26.2 Inc. Tax w/o CCRS Inf. Adj.	33% of Line 026.1	-2.3	0.3	0.8	1.2	1.6	1.6	1.3	1.1	0.8	0.5	1.5	2.6	2.5	2.4	2.3	2.2	2.2	2.1	2.0	1.9	1.8
26.3 Tax Saving to be Amortized	Line 026.2 minus,Line 026	0.0	0.3	0.4	0.6	0.6	0.7	0.9	1.1	1.2	1.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
27 Addition to Deferred Tax	Line 023 minus 026 minus 026.3	2.3	4.0	3.2	2.4	1.8	1.5	1.5	1.5	1.5	1.5	0.2	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
28 Deferred Tax Balance	Line 027 plus Previous Line 028	2.3	6.3	9.4	11.9	13.7	15.2	16.7	18.2	19.7	21.2	21.5	20.4	19.3	18.2	17.1	16.0	14.8	13.7	12.6	11.5	10.4
CASH FLOWS																						
29 Nominal Before-Tax Cash Flow	Line 024 minus Line 02	-98.3	16.5	15.3	14.5	13.6	12.8	12.0	11.1	10.3	9.4	8.5	7.8	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5
30 Real Before-Tax Cash Flow	Line 029 divided by Line 03	-98.3	15.7	13.9	12.5	11.2	10.0	8.9	7.9	7.0	6.0	5.2	4.6	4.2	3.9	3.6	3.3	3.0	2.7	2.5	2.3	2.1
31 Nominal Tax	Line 026	-2.3	0.1	0.4	0.7	0.9	0.9	0.5	.0	-0.5	-0.9	0.7	2.6	2.5	2.4	2.3	2.2	2.2	2.1	2.0	1.9	1.8
32 Real Tax	Line 031 divided by Line 03	-2.3	0.1	0.4	0.6	0.8	0.7	0.3	.0	-0.3	-0.6	0.4	1.5	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.8	0.7
33 Nominal After-Tax Cash Flow	Line 029 minus Line 031	-96.1	16.5	15.1	13.8	12.7	11.9	11.5	11.1	10.7	10.3	7.8	5.2	5.1	4.9	4.7	4.6	4.4	4.2	4.0	3.9	3.7
34 Real After-Tax Cash Flow	Line 030 minus Line 032	-96.1	15.7	13.7	11.9	10.4	9.3	8.6	7.9	7.3	6.7	4.8	3.1	2.8	2.6	2.4	2.2	2.0	1.8	1.7	1.5	1.4

LINE # ITEM	HOW DERIVED	Year: 22	23	24	25	26	27	28	29	30	31
2 Cash Invested	Data										
3 Inflation Factor	Based on Inflation Rate	2.786	2.925	3.072	3.225	3.386	3.556	3.733	3.920	4.116	4.322
CCRS DEPRECIATION											
4 Years Remaining	Based on Recovery Period	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
5 Straight-Line Fraction	1/(Line 04)	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
6 Depreciation Factor	Greater of 00% and Line 05	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
7 Balance at Start	Previous Line 07 minus 08	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
8 Depreciation Coefficient	Line 06 times Line 07	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9 Inflation Adjusted Base	Init. Investment times 03 times 07	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10 CCRS Depreciation	Line 06 times Line 09	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Difference	Line 09 minus Line 010	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RATE BASE & REVENUE REQUIREMENT											
12 Years Left	Based on Regulatory Useful Life	9.5	8.5	7.5	6.5	5.5	4.5	3.5	2.5	1.5	1.0
13 Net Depreciable Assets	Previous 013 minus Previous 014	31.7	28.3	25.0	21.7	18.3	15.0	11.7	8.3	5.0	1.7
14 Rate Base Depreciation	Line 013 divided by Line 012	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	1.7
14.1 Unamortized Bal. CCRS Inf. Adj.	Prev.(014.1 minus 014.2 plus 026.3)	3.4	3.0	2.7	2.3	2.0	1.6	1.2	0.9	0.5	0.2
14.2 Amortization CCRS Inf. Adj.	Line 014.1 divided by Line 012	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.2
15 Deferred Tax at Start	Previous Line 028	10.4	9.3	8.2	7.1	6.0	4.9	3.8	2.7	1.6	0.5
16 Net Rate Base at Start	Line 013 minus 014.1 minus 015	17.0	16.0	14.1	12.2	10.3	8.5	6.6	4.7	2.8	0.9
17 Return on Rate Base	Rate of Return times Line 016	1.6	1.5	1.3	1.1	1.0	0.8	0.6	0.4	0.3	0.1
18 CCRS Depreciation	Line 010	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
19 CCRS if Historical Cost	$100.0 times Line 08	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
21 CCRS Inflation Adjustment	Line 018 minus Line 019	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
22 Income Tax Allowance Base	Line 017 minus 014.2	1.3	1.1	0.9	0.8	0.6	0.4	0.2	0.1	-0.1	-0.1
23 Income Tax Allowance	Line 022 times (33%/(100%-33%))	0.6	0.5	0.5	0.4	0.3	0.2	0.1	.0	.0	.0
24 Total Revenue Requirement	Sum of 014, 017 & 023, minus 014.2	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.4	3.2	1.5
25 Taxable Income	Line 024 minus 018	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.4	3.2	1.5
26 Income Tax Paid	33% of Line 025	1.7	1.6	1.6	1.5	1.4	1.3	1.2	1.1	1.1	0.5
26.1 Tax.Inc. w/o CCRS Inf.Adj.	Line 025 plus Line 021	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.4	3.2	1.5
26.2 Inc. Tax w/o CCRS Inf. Adj.	33% of Line 026.1	1.7	1.6	1.6	1.5	1.4	1.3	1.2	1.1	1.1	0.5
26.3 Tax Saving to be Amortized	Line 026.2 minus Line 026	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
27 Addition to Deferred Tax	Line 023 minus 026 minus 026.3	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-0.6
28 Deferred Tax Balance	Line 027 plus Previous Line 028	9.3	8.2	7.1	6.0	4.9	3.8	2.7	1.6	0.5	.0
CASH FLOWS											
29 Nominal Before-Tax Cash Flow	Line 024 minus Line 02	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.4	3.2	1.5
30 Real Before-Tax Cash Flow	Line 029 divided by Line 03	1.9	1.7	1.5	1.4	1.2	1.1	1.0	0.9	0.8	0.4
31 Nominal Tax	Line 026	1.7	1.6	1.6	1.5	1.4	1.3	1.2	1.1	1.1	0.5
32 Real Tax	Line 031 divided by Line 03	0.6	0.6	0.5	0.5	0.4	0.4	0.3	0.3	0.3	0.1
33 Nominal After-Tax Cash Flow	Line 029 minus Line 031	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.3	2.1	1.0
34 Real After-Tax Cash Flow	Line 030 minus Line 032	1.3	1.1	1.0	0.9	0.8	0.7	0.7	0.6	0.5	0.2

CASE 2

EFFECTIVE TAX RATE FOR REGULATED INDUSTRY WITH 10% RETURN ON RATE BASE AND 30 YEAR USEFUL LIFE

ECONOMIC ASSUMPTIONS	
Inflation Rate	5.0%
First Year Use %	50.0%
REGULATORY ASSUMPTIONS	
Return on Rate Base	10.0%
Regulatory Useful Life	30
TAX ASSUMPTIONS	
Federal Tax Rate	33.0%
Declining Balance %	170%
Recovery Period	10

CALCULATED RESULTS:	
Nominal Return Before Tax	11.43%
Real Return Before Tax	6.13%
Nominal Return After Tax	10.00%
Real Return After Tax	4.76%
Nominal Effective Tax Rate	12.51%
Real Effective Tax Rate	22.28%

LINE # ITEM	HOW DERIVED	AMOUNTS Years: 1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21
2 Cash Invested	Data	100.0																				
3 Inflation Factor	Based on Inflation Rate	1.000	1.050	1.103	1.158	1.216	1.276	1.340	1.407	1.477	1.551	1.629	1.710	1.796	1.886	1.980	2.079	2.183	2.292	2.407	2.527	2.653
CCRS DEPRECIATION																						
4 Years Remaining	Based on Recovery Period	10.0	9.5	8.5	7.5	6.5	5.5	4.5	3.5	2.5	1.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
5 Straight-Line Fraction	1/(Line 04)	10.0%	10.5%	11.8%	13.3%	15.4%	18.2%	22.2%	28.6%	40.0%	66.7%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
6 Depreciation Factor	Greater of DB% and Line 05	8.5%	17.0%	17.0%	17.0%	17.0%	18.2%	22.2%	28.6%	40.0%	66.7%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
7 Balance at Start	Previous Line 07 minus 08	100.0%	91.5%	75.9%	63.0%	52.3%	43.4%	35.5%	27.6%	19.7%	11.8%	3.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
8 Depreciation Coefficient	Line 06 times Line 07	8.5%	15.6%	12.9%	10.7%	8.9%	7.9%	7.9%	7.9%	7.9%	7.9%	3.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9 Inflation Adjusted Base	Init. Investment times 03 times 07	100.0	96.1	83.7	73.0	63.6	55.4	47.6	38.9	29.2	18.4	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10 CCRS Depreciation	Line 06 times Line 09	8.5	16.3	14.2	12.4	10.8	10.1	10.6	11.1	11.7	12.2	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Difference	Line 09 minus Line 010	91.5	79.7	69.5	60.6	52.8	45.3	37.0	27.8	17.5	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RATE BASE & REVENUE REQUIREMENT																						
12 Years Left	Based on Regulatory Useful Life	30.0	29.5	28.5	27.5	26.5	25.5	24.5	23.5	22.5	21.5	20.5	19.5	18.5	17.5	16.5	15.5	14.5	13.5	12.5	11.5	10.5
13 Net Depreciable Assets	Previous 013 minus Previous 014	100.0	98.3	95.0	91.7	88.3	85.0	81.7	78.3	75.0	71.7	68.3	65.0	61.7	58.3	55.0	51.7	48.3	45.0	41.7	38.3	35.0
14 Rate Base Depreciation	Line 013 divided by Line 012	1.7	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
14.1 Unamortized Bal. CCRS Inf. Adj.	Prev.(014.1 minus 014.2 plus 026.3)	0.0	0.0	0.3	0.7	1.2	1.8	2.5	3.2	4.2	5.2	6.4	6.9	6.6	6.2	5.9	5.5	5.1	4.8	4.4	4.1	3.7
14.2 Amortization CCRS Inf. Adj.	Line 014.1 divided by Line 012	0.0	0.0	0.01	0.02	0.05	0.1	0.1	0.1	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
15 Deferred Tax at Start	Previous Line 028		2.3	6.3	9.4	11.9	13.7	15.2	16.7	18.2	19.7	21.2	21.3	20.4	19.3	18.2	17.1	16.0	14.9	13.8	12.6	11.5
16 Net Rate Base at Start	Line 013 minus 014.1 minus 015	100.0	96.1	88.5	81.3	75.2	69.5	64.0	58.4	52.6	46.7	40.7	36.8	34.8	32.9	31.0	29.1	27.2	25.4	23.5	21.6	19.7
17 Return on Rate Base	Rate of Return times Line 016		9.6	8.8	8.1	7.5	6.9	6.4	5.8	5.3	4.7	4.1	3.7	3.5	3.3	3.1	2.9	2.7	2.5	2.3	2.2	2.0
18 CCRS Depreciation	Line 010	8.5	16.3	14.2	12.4	10.8	10.1	10.6	11.1	11.7	12.2	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
19 CCRS if Historical Cost	$100.0 times Line 08	8.5	15.6	12.9	10.7	8.9	7.9	7.9	7.9	7.9	7.9	3.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
21 CCRS Inflation Adjustment	Line 018 minus Line 019	0.0	0.8	1.3	1.7	1.9	2.2	2.7	3.2	3.8	4.4	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
22 Income Tax Allowance Base	Line 017 minus 014.2	0.0	9.6	8.8	8.1	7.5	6.9	6.3	5.7	5.1	4.4	3.8	3.3	3.1	2.9	2.7	2.6	2.4	2.2	2.0	1.8	1.6
23 Income Tax Allowance	Line 022 times (33%/(100%-33%))	0.0	4.7	4.4	4.0	3.7	3.4	3.1	2.8	2.5	2.2	1.8	1.6	1.5	1.4	1.4	1.3	1.2	1.1	1.0	0.9	0.8
24 Total Revenue Requirement	Sum of 014, 017 & 023, minus 014.2	1.7	17.7	16.5	15.5	14.5	13.6	12.7	11.8	10.9	9.9	8.9	8.3	8.0	7.7	7.4	7.1	6.9	6.6	6.3	6.0	5.7
25 Taxable Income	Line 024 minus 018	-6.8	1.3	2.3	3.1	3.7	3.5	2.2	0.7	-0.8	-2.3	2.5	8.3	8.0	7.7	7.4	7.1	6.9	6.6	6.3	6.0	5.7
26 Income Tax Paid	33% of Line 025	-2.3	0.4	0.8	1.0	1.2	1.2	0.7	0.2	-0.2	-0.8	0.8	2.7	2.6	2.5	2.5	2.4	2.3	2.2	2.1	2.0	1.9
26.1 Tax.Inc. w/o CCRS Inf.Adj.	Line 025 plus Line 021	-6.8	2.1	3.6	4.7	5.6	5.7	4.8	3.9	3.0	2.0	5.0	8.3	8.0	7.7	7.4	7.1	6.9	6.6	6.3	6.0	5.7
26.2 Inc. Tax w/o CCRS Inf. Adj.	33% of Line 026.1	-2.3	0.7	1.2	1.6	1.8	1.9	1.6	1.3	1.0	0.7	1.6	2.7	2.6	2.5	2.5	2.4	2.3	2.2	2.1	2.0	1.9
26.3 Tax Saving to be Amortized	Line 026.2 minus Line 026	0.0	0.3	0.4	0.6	0.6	0.7	0.9	1.1	1.2	1.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
27 Addition to Deferred Tax	Line 023 minus 026 minus 026.3	2.3	4.0	3.2	2.4	1.8	1.5	1.5	1.5	1.5	1.5	0.2	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
28 Deferred Tax Balance	Line 027 plus Previous Line 028	2.3	6.3	9.4	11.9	13.7	15.2	16.7	18.2	19.7	21.2	21.3	20.4	19.3	18.2	17.1	16.0	14.9	13.8	12.6	11.5	10.4
CASH FLOWS																						
29 Nominal Before-Tax Cash Flow	Line 024 minus Line 02	-98.3	17.7	16.5	15.5	14.5	13.6	12.7	11.8	10.9	9.9	8.9	8.3	8.0	7.7	7.4	7.1	6.9	6.6	6.3	6.0	5.7
30 Real Before-Tax Cash Flow	Line 029 divided by Line 03	-98.3	16.8	15.0	13.4	11.9	10.7	9.5	8.4	7.4	6.4	5.5	4.8	4.4	4.1	3.8	3.4	3.1	2.9	2.6	2.4	2.2
31 Nominal Tax	Line 026	-2.3	0.4	0.8	1.0	1.2	1.2	0.7	0.2	-0.2	-0.8	0.8	2.7	2.6	2.5	2.5	2.4	2.3	2.2	2.1	2.0	1.9
32 Real Tax	Line 031 divided by Line 03	-2.3	0.4	0.7	0.9	1.0	0.9	0.5	0.2	-0.2	-0.5	0.5	1.6	1.5	1.3	1.2	1.1	1.0	0.9	0.9	0.8	0.7
33 Nominal After-Tax Cash Flow	Line 029 minus Line 031	-96.1	17.2	15.8	14.5	13.3	12.4	12.0	11.6	11.2	10.7	8.1	5.5	5.4	5.2	5.0	4.8	4.6	4.4	4.2	4.0	3.9
34 Real After-Tax Cash Flow	Line 030 minus Line 032	-96.1	16.4	14.3	12.5	10.9	9.7	9.0	8.2	7.6	6.9	5.0	3.2	3.0	2.7	2.5	2.3	2.1	1.9	1.8	1.6	1.5

EFFECTIVE TAX RATE FOR REGULATED INDUSTRY WITH 10% RETURN ON RATE BASE AND 30 YEAR USEFUL LIFE

LINE # ITEM	HOW DERIVED	Year: 22	23	24	25	26	27	28	29	30	31
2 Cash Invested	Data										
3 Inflation Factor	Based on Inflation Rate	2.786	2.925	3.072	3.225	3.386	3.556	3.733	3.920	4.116	4.322
CCRS DEPRECIATION											
4 Years Remaining	Based on Recovery Period	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
5 Straight-Line Fraction	1/(Line 04)	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
6 Depreciation Factor	Greater of DB% and Line 05	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
7 Balance at Start	Previous Line 07 minus 08	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
8 Depreciation Coefficient	Line 06 times Line 07	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9 Inflation Adjusted Base	Init. Investment times 03 times 07	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10 CCRS Depreciation	Line 06 times Line 09	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Difference	Line 09 minus Line 010	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RATE BASE & REVENUE REQUIREMENT											
12 Years Left	Based on Regulatory Useful Life	9.5	8.5	7.5	6.5	5.5	4.5	3.5	2.5	1.5	1.0
13 Net Depreciable Assets	Previous 013 minus Previous 014	31.7	28.3	25.0	21.7	18.3	15.0	11.7	8.3	5.0	1.7
14 Rate Base Depreciation	Line 013 divided by Line 012	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	1.7
14.1 Unamortized Bal. CCRS Inf. Adj.	Prev.(014.1 minus 014.2 plus 026.3)	3.4	3.0	2.7	2.3	2.0	1.6	1.2	0.9	0.5	0.2
14.2 Amortization CCRS Inf. Adj.	Line 014.1 divided by Line 012	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.2
15 Deferred Tax at Start	Previous Line 028	10.4	9.3	8.2	7.1	6.0	4.9	3.8	2.7	1.6	0.5
16 Net Rate Base at Start	Line 013 minus 014.1 minus 015	17.8	16.0	14.1	12.2	10.3	8.5	6.6	4.7	2.8	0.9
17 Return on Rate Base	Rate of Return times Line 016	1.8	1.6	1.4	1.2	1.0	0.8	0.7	0.5	0.3	0.1
18 CCRS Depreciation	Line 010	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
19 CCRS if Historical Cost	$100.0 times Line 08	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
20 CCRS Inflation Adjustment	Line 018 minus Line 019	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
22 Income Tax Allowance Base	Line 017 minus 014.2	1.4	1.2	1.1	0.9	0.7	0.5	0.3	0.1	-0.1	-0.1
23 Income Tax Allowance	Line 022 times [33%/(100%-33%)]	0.7	0.6	0.5	0.4	0.3	0.2	0.1	0.1	.0	.0
24 Total Revenue Requirement	Sum of 014, 017 & 023, minus 014.2	5.5	5.2	4.9	4.6	4.3	4.1	3.8	3.5	3.2	1.5
25 Taxable Income	Line 024 minus 018	5.5	5.2	4.9	4.6	4.3	4.1	3.8	3.5	3.2	1.5
26 Income Tax Paid	33% of Line 025	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	0.5
26.1 Tax.Inc. w/o CCRS Inf.Adj.	Line 025 plus Line 020	5.5	5.2	4.9	4.6	4.3	4.1	3.8	3.5	3.2	1.5
26.2 Inc. Tax w/o CCRS Inf. Adj.	33% of Line 026.1	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	0.5
26.3 Tax Saving to be Amortized	Line 026.2 minus Line 026	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
27 Addition to Deferred Tax	Line 023 minus 026 minus 026.3	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-0.5
28 Deferred Tax Balance	Line 027 plus Previous Line 028	9.3	8.2	7.1	6.0	4.9	3.8	2.7	1.6	0.5	.0
CASH FLOWS											
29 Nominal Before-Tax Cash Flow	Line 024 minus Line 02	5.5	5.2	4.9	4.6	4.3	4.1	3.8	3.5	3.2	1.5
30 Real Before-Tax Cash Flow	Line 029 divided by Line 03	2.0	1.8	1.6	1.4	1.3	1.1	1.0	0.9	0.8	0.4
31 Nominal Tax	Line 026	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	0.5
32 Real Tax	Line 031 divided by Line 03	0.6	0.6	0.5	0.5	0.4	0.4	0.3	0.3	0.3	0.1
33 Nominal After-Tax Cash Flow	Line 029 minus Line 031	3.7	3.5	3.3	3.1	2.9	2.7	2.5	2.3	2.2	1.0
34 Real After-Tax Cash Flow	Line 030 minus Line 032	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	0.5	0.2

CASE 3

EFFECTIVE TAX RATE FOR REGULATED INDUSTRY WITH 14% RETURN ON RATE BASE AND 30 YEAR USEFUL LIFE

ECONOMIC ASSUMPTIONS	
Inflation Rate	5.0%
First Year Use %	50.0%
REGULATORY ASSUMPTIONS	
Return on Rate Base	14.0%
Regulatory Useful Life	30
TAX ASSUMPTIONS	
Federal Tax Rate	33.0%
Declining Balance %	170%
Recovery Period	10

CALCULATED RESULTS	
Nominal Return Before Tax	16.88%
Real Return Before Tax	11.31%
Nominal Return After Tax	14.00%
Real Return After Tax	8.57%
Nominal Effective Tax Rate	17.06%
Real Effective Tax Rate	24.21%

LINE & ITEM	HOW DERIVED	AMOUNTS Years: 1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21
2 Cash Invested	Data	100.0																				
3 Inflation Factor	Based on Inflation Rate	1.000	1.050	1.103	1.158	1.216	1.276	1.340	1.407	1.477	1.551	1.629	1.710	1.796	1.886	1.980	2.079	2.183	2.292	2.407	2.527	2.653
CCRS DEPRECIATION																						
4 Years Remaining	Based on Recovery Period	10.0	9.5	8.5	7.5	6.5	5.5	4.5	3.5	2.5	1.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
5 Straight-Line Fraction	1/(Line 04)	10.0%	10.5%	11.8%	13.3%	15.4%	18.2%	22.2%	28.6%	40.0%	66.7%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
6 Depreciation Factor	Greater of DBR and Line 05	8.5%	17.0%	17.0%	17.0%	17.0%	18.2%	22.2%	28.6%	40.0%	66.7%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
7 Balance at Start	Previous Line 07 minus 08	100.0%	91.5%	75.9%	63.0%	52.3%	43.4%	35.5%	27.6%	19.7%	11.8%	3.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
8 Depreciation Coefficient	Line 06 times Line 07	8.5%	15.6%	12.9%	10.7%	8.9%	7.9%	7.9%	7.9%	7.9%	7.9%	3.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9 Inflation Adjusted Base	Init. Investment times 03 times 07	100.0	96.1	83.7	73.0	63.6	55.4	47.6	38.9	29.2	18.4	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10 CCRS Depreciation	Line 06 times Line 09	8.5	16.3	14.2	12.4	10.8	10.1	10.6	11.1	11.7	12.2	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Difference	Line 09 minus Line 010	91.5	79.7	69.5	60.6	52.8	45.3	37.0	27.8	17.5	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RATE BASE & REVENUE REQUIREMENT																						
12 Years Left	Based on Regulatory Useful Life	30.0	29.5	28.5	27.5	26.5	25.5	24.5	23.5	22.5	21.5	20.5	19.5	18.5	17.5	16.5	15.5	14.5	13.5	12.5	11.5	10.5
13 Net Depreciable Assets	Previous 013 minus Previous 014	100.0	98.3	95.0	91.7	88.3	85.0	81.7	78.3	75.0	71.7	68.3	65.0	61.7	58.3	55.0	51.7	48.3	45.0	41.7	38.3	35.0
14 Rate Base Depreciation	Line 013 divided by Line 012	1.7	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
14.1 Unamortized Def. CCRS Inf. Adj.	Prev.(014.1 minus 014.2 plus 026.3)	0.0	0.0	0.3	0.7	1.2	1.8	2.5	3.2	4.2	5.2	6.4	6.9	6.6	6.2	5.9	5.5	5.1	4.8	4.4	4.1	3.7
14.2 Amortization CCRS Inf. Adj.	Line 014.1 divided by Line 012	0.0	0.0	0.01	0.02	0.05	0.1	0.1	0.1	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
15 Deferred Tax at Start	Previous Line 028		2.3	6.3	9.4	11.9	13.7	15.2	16.7	18.2	19.7	21.2	21.5	20.4	19.3	18.2	17.1	16.0	14.8	13.7	12.6	11.5
16 Net Rate Base at Start	Line 013 minus 014.1 minus 015	100.0	96.1	88.5	81.5	75.2	69.5	64.0	58.4	52.6	46.7	40.7	36.6	34.8	32.9	31.0	29.1	27.2	25.4	23.5	21.6	19.7
17 Return on Rate Base	Rate of Return times Line 016		13.5	12.4	11.4	10.5	9.7	9.0	8.2	7.4	6.5	5.7	5.1	4.9	4.6	4.3	4.1	3.8	3.6	3.3	3.0	2.8
18 CCRS Depreciation	Line 010	8.5	16.3	14.2	12.4	10.8	10.1	10.6	11.1	11.7	12.2	6.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
19 CCRS if Historical Cost	$100.0 times Line 08	8.5	15.6	12.9	10.7	8.9	7.9	7.9	7.9	7.9	7.9	3.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
20 CCRS Inflation Adjustment	Line 018 minus Line 019	0.0	0.8	1.3	1.7	1.9	2.2	2.7	3.2	3.8	4.4	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
22 Income Tax Allowance Base	Line 017 minus 014.2	0.0	13.5	12.4	11.4	10.5	9.7	8.9	8.0	7.2	6.3	5.4	4.8	4.5	4.2	4.0	3.7	3.5	3.2	2.9	2.7	2.4
23 Income Tax Allowance	Line 022 times (33%/(100%-33%))	0.0	6.6	6.1	5.6	5.2	4.8	4.4	4.0	3.5	3.1	2.7	2.4	2.2	2.1	2.0	1.8	1.7	1.6	1.4	1.3	1.2
24 Total Revenue Requirement	Sum of 014, 017 & 023, minus 014.2	1.7	23.4	21.8	20.3	19.0	17.7	16.6	15.3	14.0	12.7	11.4	10.5	10.1	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9
25 Taxable Income	Line 024 minus 018	-6.8	7.1	7.6	7.9	8.2	7.7	6.0	4.2	2.4	0.5	4.9	10.5	10.1	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9
26 Income Tax Paid	33% of Line 025	-2.3	2.3	2.5	2.6	2.7	2.5	2.0	1.4	0.8	0.2	1.6	3.5	3.3	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.3
26.1 Tax.Inc. w/o CCRS Inf.Adj.	Line 025 plus Line 020	-6.8	7.9	8.9	9.6	10.1	9.9	8.7	7.4	6.2	4.9	7.4	10.5	10.1	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9
26.2 Inc. Tax w/o CCRS Inf. Adj.	33% of Line 026.1	-2.3	2.6	2.9	3.2	3.3	3.3	2.9	2.4	2.0	1.6	2.4	3.5	3.3	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.3
26.3 Tax Saving to be Amortized	Line 026.2 minus Line 026	0.0	0.3	0.4	0.6	0.6	0.7	0.9	1.1	1.2	1.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
27 Addition to Deferred Tax	Line 023 minus 026 minus 026.3	2.3	4.0	3.2	2.4	1.8	1.5	1.5	1.5	1.5	1.5	0.2	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
28 Deferred Tax Balance	Line 027 plus Previous Line 028	2.3	6.3	9.4	11.9	13.7	15.2	16.7	18.2	19.7	21.2	21.5	20.4	19.3	18.2	17.1	16.0	14.8	13.7	12.6	11.5	10.4
CASH FLOWS																						
29 Nominal Before-Tax Cash Flow	Line 024 minus Line 02	-98.3	23.4	21.8	20.3	19.0	17.7	16.6	15.3	14.0	12.7	11.4	10.5	10.1	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9
30 Real Before-Tax Cash Flow	Line 029 divided by Line 03	-98.3	22.3	19.8	17.6	15.6	13.9	12.4	10.9	9.5	8.2	7.0	6.1	5.6	5.1	4.7	4.3	3.9	3.5	3.2	2.9	2.6
31 Nominal Tax	Line 026	-2.3	2.3	2.5	2.6	2.7	2.5	2.0	1.4	0.8	0.2	1.6	3.5	3.3	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.3
32 Real Tax	Line 031 divided by Line 03	-2.3	2.2	2.3	2.3	2.2	2.0	1.5	1.0	0.5	0.1	1.0	2.0	1.8	1.7	1.6	1.4	1.3	1.2	1.1	1.0	0.9
33 Nominal After-Tax Cash Flow	Line 029 minus Line 031	-96.1	21.1	19.3	17.7	16.3	15.2	14.6	13.9	13.3	12.6	9.7	7.0	6.7	6.5	6.2	6.0	5.7	5.4	5.2	4.9	4.6
34 Real After-Tax Cash Flow	Line 030 minus Line 032	-96.1	20.1	17.5	15.3	13.4	11.9	10.9	9.9	9.0	8.1	6.0	4.1	3.8	3.4	3.1	2.9	2.6	2.4	2.1	1.9	1.7

[illegible] 14% RETURN ON RATE BASE AND 30 YEAR USEFUL LIFE

LINE & ITEM	HOW DERIVED	Year:	22	23	24	25	26	27	28	29	30	31
2 Cash Invested	Data											
3 Inflation Factor	Based on Inflation Rate		2.786	2.925	3.072	3.225	3.386	3.556	3.733	3.920	4.116	4.322
CCRS DEPRECIATION												
4 Years Remaining	Based on Recovery Period		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
5 Straight-Line Fraction	1/(Line 04)		100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
6 Depreciation Factor	Greater of 00% and Line 05		100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
7 Balance at Start	Previous Line 07 minus 08		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
8 Depreciation Coefficient	Line 06 times Line 07		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9 Inflation Adjusted Base	Init. Investment times 03 times 07		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10 CCRS Depreciation	Line 06 times Line 09		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Difference	Line 09 minus Line 010		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RATE BASE & REVENUE REQUIREMENT												
12 Years Left	Based on Regulatory Useful Life		9.5	8.5	7.5	6.5	5.5	4.5	3.5	2.5	1.5	1.0
13 Net Depreciable Assets	Previous 013 minus Previous 014		31.7	28.3	25.0	21.7	18.3	15.0	11.7	8.3	5.0	1.7
14 Rate Base Depreciation	Line 013 divided by Line 012		3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	1.7
14.1 Unamortized Bal. CCRS Inf. Adj.	Prev.(014.1 minus 014.2 plus 026.3)		3.4	3.0	2.7	2.3	2.0	1.6	1.2	0.9	0.5	0.2
14.2 Amortization CCRS Inf. Adj.	Line 014.1 divided by Line 012		0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.2
15 Deferred Tax at Start	Previous Line 028		10.4	9.3	8.2	7.1	6.0	4.9	3.8	2.7	1.6	0.5
16 Net Rate Base at Start	Line 013 minus 014.1 minus 015		17.9	16.0	14.1	12.2	10.3	8.5	6.6	4.7	2.8	0.9
17 Return on Rate Base	Rate of Return times Line 016		2.5	2.2	2.0	1.7	1.4	1.2	0.9	0.7	0.4	0.1
18 CCRS Depreciation	Line 010		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
19 CCRS if Historical Cost	$100.0 times Line 08		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
21 CCRS Inflation Adjustment	Line 018 minus Line 019		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
22 Income Tax Allowance Base	Line 017 minus 014.2		2.1	1.9	1.6	1.4	1.1	0.8	0.6	0.3	.0	.0
23 Income Tax Allowance	Line 022 times (33%/(100%-33%))		1.1	0.9	0.8	0.7	0.5	0.4	0.3	0.1	.0	.0
24 Total Revenue Requirement	Sum of 014, 017 & 023, minus 014.2		6.5	6.1	5.7	5.4	5.0	4.6	4.2	3.8	3.4	1.6
25 Taxable Income	Line 024 minus 018		6.5	6.1	5.7	5.4	5.0	4.6	4.2	3.8	3.4	1.6
26 Income Tax Paid	33% of Line 025		2.2	2.0	1.9	1.8	1.6	1.5	1.4	1.2	1.1	0.5
26.1 Tax.Inc. w/o CCRS Inf.Adj.	Line 025 plus Line 021		6.5	6.1	5.7	5.4	5.0	4.6	4.2	3.8	3.4	1.6
26.2 Inc. Tax w/o CCRS Inf. Adj.	33% of Line 026.1		2.2	2.0	1.9	1.8	1.6	1.5	1.4	1.2	1.1	0.5
26.3 Tax Saving to be Amortized	Line 026.2 minus Line 026		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
27 Addition to Deferred Tax	Line 023 minus 026 minus 026.3		-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-0.6
28 Deferred Tax Balance	Line 027 plus Previous Line 028		9.3	8.2	7.1	6.0	4.9	3.8	2.7	1.6	0.5	.0
CASH FLOWS												
29 Nominal Before-Tax Cash Flow	Line 024 minus Line 02		6.5	6.1	5.7	5.4	5.0	4.6	4.2	3.8	3.4	1.6
30 Real Before-Tax Cash Flow	Line 029 divided by Line 03		2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.4
31 Nominal Tax	Line 026		2.2	2.0	1.9	1.8	1.6	1.5	1.4	1.2	1.1	0.5
32 Real Tax	Line 031 divided by Line 03		0.8	0.7	0.6	0.5	0.5	0.4	0.4	0.3	0.3	0.1
33 Nominal After-Tax Cash Flow	Line 029 minus Line 031		4.4	4.1	3.9	3.6	3.3	3.1	2.8	2.5	2.3	1.1
34 Real After-Tax Cash Flow	Line 030 minus Line 032		1.6	1.4	1.3	1.1	1.0	0.9	0.7	0.6	0.6	0.2

Senator SYMMS. The witness before you said that the Department of Energy study released last month concluded that Treasury II would reduce the electric utilities industry's tax liability by approximately $4 billion. You just stated that if certain things aren't done to the bill, you would oppose it. Do you not agree, then, that it would reduce taxes on utilities?

Mr. NOFTZ. We believe that it will reduce taxes on utilities. Yes, sir. But that eventually, as we go on, over a period of years, the rates that we will have to charge to customers will go up because our tax payments will be going up.

Senator SYMMS. Thank you very much.

Mr. Doerr, you covered several areas in your testimony, but I don't think I picked up on your comments about the Ways and Means Committee proposal to terminate treatment under current law for investment credit as of September 25. What will happen in the West, specifically with the Mountain Bell, if the investment tax credit is cut off on September 25. What would this do to construction plans in the West?

Mr. DOERR. First of all, most of our long-range plans are not subject to contractual arrangement. Accordingly, September 25 cutoff doesn't signficantly help us. We do long-range planning—construction, engineering design plans. They go 3 to 5 years out into the future. In 1984, the Mountain States Telephone companies in their seven States invested $840 million. Over $80 million of that came from investment tax credits. This year, that expenditure will exceed $940 million. And nearly another $90 million will be supported from investment tax credits.

We already can anticipate, based upon engineering studies and demand studies, that in 1986 they will invest an additional $970 million. Most of this is things that are bought not by long-term contractual arrangements, but from the shelf under contractual arrangements that are made out into the future.

Senator SYMMS. When the Congress passes laws and sets these depreciation schedules based on technology, what happens if a certain time length is set and then technology changes? Will that have an tax impact?

Mr. DOERR. It certainly will have an impact, Senator. In fact, I first of all must say that we were pleased to see that the proposed Ways and Means staff option did correct the imbalance that I made reference to in my prepared remarks about treating computers in central offices with the same life for depreciation purposes, which was 5 years. But, unfortunately, they reversed themselves in another area of extremely expensive technology, and that's in our outside plant. And if I may, I can show you that this is—this is yesterday's technology. This is a cable, and there are 4,800 voice circuits in that. And cable today for tax purposes is being depreciated over 15 years. This fiber multimode cable is a technology of 5 years ago. It takes 14 of these to provide the same capacity as one of these, single nonfiber opticcables. And, again, it is being depreciated in 15 years today.

This fiber is today's technology. In 5 years it has become obsolete. And the House is now proposing that all of this be subject to a 30-year life. So where they correct an imbalance on central office and computers, they go just the reverse of it for outside plant. And in our territory, we are going to be installing thousands and thousands and thousands of miles of this technology. And we can't tell you what the technology 5 years from now will be.

Senator **Symms**. So you are saying it should be on a 5-year depreciation schedule?

Mr. **Doerr**. No. I'm willing to say that in Treasury II they are talking about 10 years and we feel that that is at least the minimum it ought to be.

Senator **Symms**. Thank you very much for an excellent statement.

Senator Grassley.

Senator **Grassley**. I don't know, Mr. Doerr—he asked specifically about Mountain Bell and Northwestern Bell. Is that included in your response to Senator Symms' question?

Mr. **Doerr**. The concept as far as depreciation is generic to the entire industry. I gave some specific numbers to Mountain Bell in response to Mr. Symms' question. I would have a different set of numbers for Northwestern Bell and even in your particular case, representing the State of Iowa. This year, we will expend something in excess of $112 million in a new capital program and almost $11 million of that is coming from the benefits of the investment tax credits. And so it is significant in all of our territory. And it certainly is significant in any serving territory that is rather high-growth as we envision our 14-state area to be.

Senator **Grassley**. Each of you have spoken to the impact of the tax laws on the activities as a company. Maybe implicit in there is negative or positive as far as the customer is concerned. But I would like to have your general reaction to whether or not you think the customers are better off or worse off with tax proposals as suggested.

Mr. **Smith**. If I may, Senator, I would suggest that they are worse off. The one thing that we do have in this country is an efficient, well-run telecommunications industry. And that's based on a longstanding encouragement by this Government and this committee for the formation of capital. That capital has been well spent in terms of all of the modernization that Mr. Doerr referred to and others.

In this bill for Bell Atlantic alone, for the next 5 years, we will see $2 billion of capital disappear. Across the United States, approximately $30 billion will disappear.

We have a choice. We will have the opportunity to reduce our construction programs, to reduce the modernization of our telecommunications network, or to pay very much higher costs of capital. We think that some sort of combination of those two things will take place. And when that occurs, it could very well be that the customers of the telecommunications industry will be getting less for more.

Senator **Grassley**. Anybody else want to comment?

Mr. **Foley**. I'd like to take a crack at that one, if I might. It seems to me, Senator, that there are really two issues on the table. And I would like to take one of the issues off the table. The first issue is the whole level of Federal taxation that the Congress deems to be appropriate for utility companies. And I think in the case of telecommunications industry the direction of the administration's proposal is to impose a higher tax burden on that industry. In the case of the electric industry, it seems to be a lessening of that corporate tax burden.

These are issues clearly within the jurisdiction of the Finance Committee.

The second issue, however, is the whole question of the ratemaking policies to properly account for those tax benefits. And this is an issue that we have seen Congress time and time again get involved in. You have included language into the tax law which specifically carves into the law certain ratemaking techniques. And as I mentioned earlier, this tends to distort the whole ratesetting process. The Reagan administration has acknowledged that. The Carter administration acknowledged it. The Congressional Research Service, State commissioners, the consumer advocates. All the parties agree with one exception and that's the utility lobbyists. They seem to have carried the day.

Mr. **Lawrence**. Could I just add, Senator?

Senator **Grassley**. Yes.

Mr. **Lawrence**. We in the natural gas industry have been spared the direct criticism aimed at the electric utilities, but I would say that we think the normalization rules that this committee has passed, which is the current law, are absolutely essential. It is the proper subject of this forum, we submit, as to whether there should be investment tax credit and what the depreciation schedules should be. Those subjects that are either tax incentives or disincentives are the properly discussed by the committee. As to whether or not there should be normalization, you have already decided that issue correctly. You should retain normalization because without it all you have done with any tax incentive is provide a rate decrease. And that has not been your intention. Your intention has been and is capital formation.

I've heard the words phantom tax tossed around in these hearings dozens of times. But without normalization retained in the present law, you are providing phantom incentives, not phantom taxes.

Mr. **Foley**. May I respond to that?

Senator **Grassley**. Yes.

Mr. **Foley**. What the Reagan administration proposed in 1981 was a continuation of normalization of the investment tax credit. All they were seeking to do was to clarify a technical problem with normalization. The incentive created under the current investment tax credit scenario is in excess of what it should be. It's in excess of what is provided to nonregulated industries. And the Reagan administration was simply trying to level that.

Senator **Symms**. Mr. Smith.

Mr. **Smith**. Just one comment. I don't think that normalization of the investment tax credit is a technical problem at all. It's a philosophical problem. It is a tax incentive. I can't speak for the electric industry, but I can speak for the telephone industry. It has worked very well. We right now have the lowest cost industry relative to the rest of the world in all of American industry. That capital formation that came from the investment tax credit acted as an incentive; not an artificial lowering of rates. It's not a technical question. It's a genuine incentive question. It has worked well. Normalization should stay. And I respectfully disagree with the gentleman.

Senator SYMMS. Thank you very much, gentlemen. It was an excellent panel. We appreciate all the witnesses that testified here this morning.

And the committee is adjourned.

[Whereupon, at 11:57 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF THE
ASSOCIATION OF AMERICAN RAILROADS
BEFORE THE
COMMITTEE ON FINANCE
U.S. SENATE
ON
THE PROPOSALS FOR TAX REFORM

October 18, 1985

The Association of American Railroads, with headquarters in Washington, D.C., represents the nation's freight railroads. The railroads which are members of the Association operate 92 percent of the line-haul mileage, employ 94 percent of the workers and account for 97 percent of the freight revenues of all railroads in the United States.

We appreciate the opportunity to offer these comments presenting the views of the railroad industry on the Treasury II proposal and the recent option prepared by the Joint Committee on Taxation for consideration by the Ways and Means Committee. As a highly capital intensive industry, we are obviously concerned over the capital recovery aspects of these proposals.

Our industry joins virtually all industries in telling you that we support the stated goals of tax reform -- fairness, growth and simplicity. While we appreciate the political necessity of reasonable compromise in reaching these goals, the proposals before you clearly place an unduly heavy burden on capital intensive industries of which the railroad industry is one of the major elements. We urge the Committee to preserve a favorable climate for productive capital investments. In light of the unemployment in the nation's capital-intensive industries, their generally inadequate financial posture, and the growing pressures they face in international markets, the nation cannot afford a tax system that creates substantial disincentives for capital formation.

Last year the railroad industry had revenues of $29.5 billion, employed over 303,000 people, and made capital expenditures of $4.3 billion. We also incurred approximately $3.3 billion in taxes to Federal, State and local governments -- the equivalent 122 percent of our $2.7 billion in net income.

As we view these proposals, they will cause a drastic decline in the cash flow of all railroads. In the first five years under the Treasury II proposal, we calculate a loss of over $2 billion -- the vast majority of which will be telescoped into the first three years. For a typical major rail company, the five year losses will approximate over $330 million. Under the Joint Committee's option, those five-year losses double -- over $4 billion for the industry and $660 million for a major railroad. And those losses assume our customers do not suffer. In truth, many of our major users will be similarly affected. If the domestic automobile, steel, chemical, and mining industries are forced to reduce their levels of production, our traffic levels will decline and in the long run our ability to serve them will be impaired. So in effect, we will suffer at least a double whammy -- the inevitable prospect of lower profits and higher taxes.

Tax reform is a laudable goal, but it cannot be considered in a vacuum. If, because of tax reform, our basic industries are stripped of their ability to compete in the market-place, then the economy in general and the railroads in particular would lose more than they will gain from the reform movement, even if it were neutral to the railroads. To redistribute the corporate tax burden from one sector of the economy to another doesn't make much sense if the result is to do serious damage to much of industrial America.

Ours is a large nation, with more than 100 million people holding down full-time jobs. Our country cannot exist solely as a service or a high tech economy. Instead, we must be a broad-based economy that can more or less do it all, particularly from the standpoint of national security. If not, we are going to create massive unemployment problems and cause great social and economic upheavals that could have very serious political implications.

The Treasury II Proposal - An Analysis

General

The proposal calls for higher overall corporate taxes to help pay for rate reductions for individuals. Within the corporate sector, the tax increase aspects of the plan are focused disproportionately on the capital intensive sector. Companies in basic and heavy industries, through changes in the capital cost recovery system, would pay considerably more in taxes over the next five years than under the current system. The beneficial provisions of the plan, such as lower corporate tax rates, do not come close to offsetting this serious blow to America's industry. According to initial Treasury estimates, corporations will pay an additional $120 billion in taxes. However, capital intensive industries will contribute more than 100 percent of this amount, while service industries would pay less than their current levels.

ACRS/ITC

The proposal repeals both the investment credit (ITC) and the Accelerated Cost Recovery System (ACRS) and substitutes a new depreciation system (Capital Cost Recovery System - CCRS). These proposals will promote neither economic growth nor employment in the United States.

CCRS is less generous than the combination of ACRS/ITC which yield approximately the present value equivalent of expensing for capital investments -- its purpose when enacted by Congress. Although more favorable than the Treasury I original depreciation plan (RCRS), the Treasury II proposal moves capital investment away from the parity with labor and services that should be maintained.

On a present value basis, the new depreciation plan may, depending on the property category and the discount rate, approximate the current capital recovery system in the long run. However, initially the proposed CCRS depreciation substitute will be negative.

In any event when the loss of the ITC is added into the equation, capital intensive industries are clearly major losers. And as internal cash flow in the corporate sector falls, the pressure on borrowing and interest rates must rise.

It is argued that these losses from abandoning ACRS and ITC will be offset by the benefits in the proposal, most predominantly the lower corporate tax rates. The benefit of the rate reduction is dependent on the ratio of a company's earnings to its capital expenditures. As this ratio increases, so does the benefit of the rate reduction. However, the railroad industry and other major capital intensive industries have historically had a low ratio of earnings to capital expenditures, as evidenced by their extremely low rates of return. Consequently, the rate reduction is far less beneficial to the railroad industry than it is to non-capital intensive companies. If the proposal stopped there, the objections -- at least within the railroad industry -- would be constrained. But it does not!

Recapture Tax

The most devastating aspect of Treasury II is the recapture tax -- a provision which requires taxpayers to include in income over a three-year period 40 percent of accelerated depreciation claimed between January 1, 1980 and July 1, 1986 on assets placed in service during 1980 through 1985. This is tantamount to a retroactive change in Federal tax law as it nullifies benefits of ACRS for property placed in service during 1981 through 1985 and ADR depreciation for property placed in service in 1980. The rationale for including assets placed in service in 1980 is unclear since their cost was not recovered under ACRS.

This recapture provision is particularly punitive to capital intensive industries. Many companies invested in plant and equipment as a result of ACRS which was enacted in the Economic Recovery Tax Act of 1981. It is unjust to penalize these companies that stimulated the economy when they were encouraged to do so by the 1981 Act.

This provision is the major reason why a disproportionate share of the revenue-raising burden in the proposal is borne by capital intensive industries during the first three years. Railroads, in particular, would be most severely affected due to their large amount of track-related expenditures -- a goal encouraged by the Federal government for the past two decades.

As the Committee is aware, under the 1981 Act, railroads were required to depreciate expenditures for track replacements installed during 1981 through 1984 over a recovery period which ranged from one year in 1981 to four years in 1984. Prior to the 1981 Act, railroads were entitled to deduct the entire cost of track replacements in the year the expense was incurred, using the retirement-replacement-betterment (RRB) method of accounting.

When the 1981 Act was in its formative stages, Treasury was insistent on having all taxpayers, including railroads, adopt ACRS. Consequently, the railroads were required to abandon the RRB method and adopt ACRS beginning in 1981. To mitigate the potentially severe impact of an abrupt change from a one-year write-off of track replacements to recovering the cost over a five-year period, Treasury agreed to phase-in ACRS for track replacements over a five-year period. This depreciation recapture provision retroactively cancels the benefits of this transitional rule and the railroad industry's understanding with Treasury. As a result, the excess depreciation of railroads will be greater than that of taxpayers in other industries having the same amount of capital expenditures.

The reason given for this recapture is to prevent taxpayers from obtaining an unexpected windfall which would result from the proposed reduction in the corporate tax rate from 46 to 33 percent. This provision presupposes that depreciation deductions claimed prior to 1986 received a 46 percent tax benefit at the time the asset was purchased, and that future income generated by the asset will be taxed at only 33 percent. However, the truth of the matter is that many companies, mainly because the ITC and operating loss carry forwards lowered their rates well below 46 percent, received a much smaller benefit. Since the windfall never fully occurred, the tax functions as a penalty rather than as a windfall recapture. Such a penalty tax should not be an element of true tax reform.

In addition, the recapture occurs in the first three years -- a far shorter period than if capital intensive industries had calculated their depreciation on a straight line basis. In other words, by moving up the windfall recapture, more money is calculated than if the benefits never occurred.

Finally, the tax hurts the same companies that are most adversely affected by other provisions of the Treasury II plan -- the capital intensive companies in basic industries.

Why was depreciation selected as the only target for the revenue-raising penalty tax? Rate reduction will always bring with it certain "windfalls". Shareholders of corporations that pay less under the proposal will experience a windfall increase in the value of their stock. Noteholders who set interest rates on long-term loans anticipating a 46 percent tax rate will receive unexpected benefits. So will corporations that are recovering greater cash as a result of research credits and other tax incentives built by the Congress.

Business needs certainty to make sound investment decisions. Retroactive taxes unnecessarily complicate the investment process, make long-term investments even riskier and cause taxpayers to lose faith in government. It is noteworthy, that the academic and economic experts assembled at the recent Ways and Means Committee's retreat were unanimous in their opposition to this retroactive provision.

The Joint Committee Option -- An Initial Reaction

On September 26, 1985, the Joint Committee on Taxation released its Summary of Tax Reform Option for Consideration by the Committee on Ways and Means. The railroad industry's initial analysis of this proposal indicates that the devastating losses estimated under the Treasury II proposal would be at a minimum doubled. This Joint Committee proposal is ill-conceived and would result in irreparable harm to the nation as a whole. In an attempt to provide a quick-fix to the highly criticized portions of the Treasury II proposal and to remain "revenue neutral", this proposal has simply ignored many of the stated tax-reform goals.

The capital recovery provisions of this proposal are so inadequate that they seriously threaten the viability of the nation's basic industries. By eliminating ITC and more than doubling the recovery period for most assets, the proposal will increase the cost of many capital replacements beyond the point of affordability. The result will be an accelerated crumbling of the nation's industrial infrastructure. In regressing from the Treasury II proposal, this proposal extends the recovery period of railroad assets from seven to 11 years and eliminates indexation of depreciation. Over a five-year period, this change more than offsets the cost of recapture in the Treasury II proposal, and in the longer term never permits the full recovery of railroad capital costs. In addition, railroads are put in the precarious position of having track temporarily assigned to Class 4 property until the Treasury performs a study of its ADR midpoint.

The benefit from the rate change, which even under the Treasury II proposal did not offset its capital recovery cost, is diminished as well. As feared, the maximum rate has moved its way upward from 33 to 35 percent and many believe that this is only a first step. In addition, the minimum corporate tax rate has increased to 25 percent which is precariously close to the maximum 35 percent rate. Our fear is that capital intensive industries such as railroads could, by simply making required capital investments, get caught in a continuing minimum-tax spiral.

Beyond these devastating effects, the proposal eliminates the preferential tax rate for capital gains and initially reduces the dividends paid deduction to almost an imperceptible level.

To provide some idea of the degree of harm this proposal would generate over a longer term, we compared it to the cost of the Treasury II proposal for 11 years. We estimate that this proposal would cost the railroad industry an unconscionable $9 billion dollars over 11 years, assuming we could survive that long. It is clearly a case of a bad idea gone astray.

Impact on the Railroad Industry

These proposals result in a redistribution of the tax burden from individuals to corporations and within the corporate sector from service and high-tech industries to capital intensive companies. And the railroad industry, which is very capital intensive, would bear a significant portion of this redistribution.

The lost cash flow to our industry resulting from the proposals is staggering. Over the five year period 1986-1990, we would suffer a cash flow loss of $2 to $4 billion. Among major railroads, the loss would average approximately $330 to $660 million per railroad, even if their business levels remained the same, a gossamer hope at best.

Such reductions will produce lower capital investments which mean lost jobs. Reduced orders of capital goods on our part and other similarly situated industries as a result of the cash loss attributed to this tax program has to affect employment adversely in those domestic industries which produce such goods, e.g., steel, aluminum, autos, etc.

The proposed depreciation methods coupled with the repeal of the investment tax credit represent another major setback for capital formation. Since 1980, our after-tax cost of investing in new track has steadily increased, primarily due to changes in tax policy. Prior to 1981, under the RRB accounting method, a one dollar investment in replacement track cost the typical railroad 50¢. In 1981, with the enactment of ERTA, our after-tax cost of a one dollar investment in track increased to 56¢. In 1982, after the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, which required taxpayers to reduce depreciable basis or investment tax credit, our after-tax cost of a one dollar investment in track increased to 58¢. Under the Treasury II proposal, the after-tax cost of a one dollar investment in track will rise to 74¢. And finally under the Joint Committee's proposal it increases to 79¢. (These amounts were all computed for 1986 using a discount rate of 10 percent and assuming an annual inflation rate of 5 percent.)

The proposals must also be reviewed in the context of its impact on our customers. Our level of employment and capital expenditures depends upon the health of our customers. If the proposals cause manufacturing companies to move offshore or if the new cost recovery provisions impede U.S. industry's ability to compete, resulting in reduced demand, our industry will be hurt. For example, autos and auto parts, chemical, minerals, ores, and coal are of particular importance to the railroads. Together they constitute half of our freight revenues. Each of these industries is likely to suffer under the Treasury II proposal because of the higher cost to produce their goods. It is inevitable that if capital investment is penalized, not only will our key customers do less business, but so will the railroad industry and its suppliers.

Impact on Nation

The proposals are fraught with risk and uncertainties from our nation's perspective. Among the potential results are less investment, lower productivity, fewer jobs, smaller GNP, greater budget deficits, larger trade deficits, and higher interest rates.

For example, the increase in the cost of capital equipment in the U.S. will further impair the ability of U.S. companies to expand and modernize plants and equipment, continue to diminish the international competitiveness of U.S. companies and workers, and increase the vulnerability of U.S. production and jobs to imports. Moreover, the combined effect of increasing the tax cost of U.S. manufacturing while decreasing the tax on sales of goods in the U.S. market, and the more favorable cost recovery systems which exist in other industrialized nations, would actually provide an incentive for U.S. companies to manufacture goods abroad for sale back into the U.S. The results would be a substantially increased trade deficit and a significant loss of jobs. The commonly used rule of thumb is that for every loss of $1 billion in investment, there is a corresponding loss of 50,000 jobs. Thus, for example, a $30 billion loss in investment in the capital-intensive sector implies a loss of 1.5 million in jobs.

If ACRS and ITC were to be jettisoned in favor of either the CCRS or Joint Committee's depreciation systems, the U.S. would rank near last or dead last, respectively in the industrialized world in cumulative cost recovery deductions allowed for most equipment through the first three years that the equipment is in service.1/ This surely would cause the U.S. to be less competitive

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1/ This is based upon a study by Arthur Anderson and Co., which compared the cost recovery deductions of the U.S. with those of 15 industrialized countries.

with its principal international competitors in terms of cumulative cost recovery deductions allowed in the critical early years following the time the equipment is placed in service.

Proponents of this proposal tell us that jobs lost in manufacturing will tend to be absorbed in the service sector of the economy in the long run. However, the transition, if it ever occurs, necessarily will be slow and painful. Moreover, this shift in the composition of employment would be very costly to the economy. Wages in the service sector, on average, are considerably lower than in manufacturing. A substitution of service jobs for manufacturing jobs will result in a lower average wage level for the economy as a whole. In addition, the transition will create "structural" unemployment, which is costly in terms of lost income, tax revenues, and outlays for unemployment compensation.

Arguments to the effect that cost recovery allowances should be reduced because so-called basic industries do not pay taxes or that they have drastically lower so-called "effective tax rates" should be examined very carefully and, in my view, be rejected.2/

In the railroad industry, for example, the effective tax rates during the 1980-1984 period were relatively low. The basic reasons for those low rates are straight forward. First, having

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2/ A recent study concludes that overall marginal effective rates do not differ between the basic industry and high tech sectors. In any event, differences in such rates, to the extent they may arise, are not caused by the tax treatment of depreciable assets. See Don Fullerton and Andrew B. Lyon, Does The Tax System Favor Investment in High Tech or Smoke-Stack Industries?, Working Paper No. 1600, Natural Bureau of Economic Research, Inc., April 1985.

earned less than two percent on its investment before interest payments for over a decade, many carriers had huge loss carry forwards. Second, the recession in this period caused a severe decline in profits. Third and last, the Treasury's changes in depreciation for track investments, made solely at its urging, increased deductions in the 1981-1985 period. All of these phenomena have now passed for most railroads and we are facing effective tax rates well above the average experienced by U.S. industries, providing our profit trend continues, even if no tax changes are made.

Conclusion

One need only to look to the recent past to see the importance of an appropriate investment climate. In 1981, our country was experiencing severe economic problems. During the decade of the 1970's and the early 1980's, the United States had one of the lowest rates of productivity growth, capital formation and savings of any of the major industrialized nations. The serious decline in productivity growth resulted in the concurrent loss of our ability to compete with other nations.

In 1981, through the Economic Recovery Tax Act (ERTA), Congress demonstrated its awareness of the importance of a tax system that would produce a favorable climate for capital investment. The cost recovery provisions of ERTA (ACRS/ITC) provided a much needed cash flow injection for business, which reduced the need to borrow and thus helped decrease interest rate pressures.

Our statistics on productivity have also shown a remarkable improvement. While the United States ranked last in 1979 (compared with its major trading partners), it is now second only to Canada in productivity. One of the primary factors in the improved productivity has been the modernization of plant and equipment. In 1983, for the first time in a decade, the U.S. edged out Japan in the race for the world's most modern facilities.

ACRS/ITC has worked. It has been recognized that business fixed investment has been a major factor in the economic recovery. Over the past two years, real capital expenditures increased at a 15 percent annual rate, a record by all historical standards. And during the earlier recession, the combination of these provisions prevented a more serious decline in business capital outlays than might have been expected.

To step back now from the advance made in capital recovery in ERTA is to regress to a pattern of capital formation and job creation worse than that which existed in the 1970's. Such a regression, especially in the name of fairness, growth, and simplicity is painfully ironic to the railroad industry. We believe, in order for the tax reform benefits to be borne equitably by all sectors of the taxpaying public -- individuals, service/hi-tech industries, and capital intensive businesses, that any change in the federal income tax system should take into consideration the total tax burden of business from all taxing authorities. Railroads already bear a heavier burden than the average company in terms of employment taxes. Railroad retirement taxes are three times higher than the Social Security (FICA) taxes paid by non-railroad employers. Railroads also have a heavier property tax burden than most companies. To focus strictly on a company's federal income tax liability simply is not representative of the entire picture. With respect to simplicity, we believe that for corporations these proposals would clearly increase the cost of complying with the tax law. And this burden, too, would fall heaviest on capital intensive companies. We are convinced that the proposals would reduce our capital spending and increase unemployment. We hope that your Committee plans to move cautiously in dealing with the tax reform proposals which could have some very damaging effects on our industry, the economy, and our nation's long-term prosperity.

We suggest that if your Committee finds it necessary to advance any of the current tax reform proposals, it should modify the Treasury II proposal by phasing in the rate reductions for individuals and corporations, by gradually phasing out the investment tax credit, and by eliminating the depreciation recapture provision. We also believe that other forms of taxation should be examined, such as a consumption or value added tax, in conjunction with the overall issue of tax reform. Finally, additional reductions in federal spending are essential.

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Written Statement of the
COGENERATION COALITION OF AMERICA, INC.
Before the
UNITED STATES SENATE COMMITTEE ON FINANCE
Regarding
THE PRESIDENT'S TAX REFORM PROPOSAL
October 3, 1985

Mr. Chairman and Members of the Committee:

The members of the Cogeneration Coalition of America, Inc. (the "Coalition") appreciate the opportunity to submit written comments to the Finance Committee on the President's Tax Reform Proposal. The Coalition is a non-profit corporation, a key purpose of which is to represent the interests of the cogeneration industry before Congress and the Executive Branch, and to support the adoption of comprehensive national energy and tax policies which encourage cogeneration development nationwide.

The President's tax reform proposal would alter the current distinction, for depreciation purposes, between investments by regulated utilities and investments by non-regulated cogenerators. Our written statement will explain why that distinction should be maintained.

Cogeneration Is An Efficient Approach to Energy Production

Cogeneration is the sequential production of both electrical (or mechanical) energy and useful thermal energy from the same primary energy source. Cogeneration systems recapture otherwise wasted thermal energy -- usually from a combustion or steam turbine, diesel, or reciprocating engine producing electric power -- and use it for applications such as space heating or cooling, industrial process requirements, or water heating. While conventional energy systems supply either electricity or thermal energy, a cogeneration system provides both forms of energy to multi-family residential, commercial and industrial users.

Cogeneration is not a new technique for producing energy. At the beginning of this century, oil- and gas-fired cogeneration technologies produced almost 60 percent of the nation's electricity. That changed significantly, however, as electric utilities were able to offer reliable, cheap electricity across the country. By 1980, cogeneration and other on-site generation sources accounted for approximately 3 percent of total U.S. generating capacity, which steadily increased to 7 percent by 1984.

The equipment used in the design and development of cogeneration systems is not exotic. Cogeneration systems are composed of varied components, including combustion and steam turbines, reciprocating engines, stoker-fired boilers, fluidized-bed combustors, waste heat recovery equipment, and related piping and wiring. These component parts have varying useful lives.

A principal advantage of cogeneration systems is their ability to improve the efficiency of fuel use. A cogeneration facility, in producing both electrical and thermal energy, usually consumes more fuel than is required to produce either form of energy alone. However, the total fuel required to produce both electrical and thermal energy in a cogeneration system is less than the total fuel required to produce the same amount of power and heat separately. Typically, ten barrels of oil, or an equivalent fuel, used in a cogeneration system will produce the same amount of electricity and thermal energy as conventional systems will produce when using thirteen barrels.

Because of these savings, cogeneration systems can lower the cost of electrical and thermal energy by 25 to 30 percent, even after the costs of equipment, maintenance, and other operating expenses are included. Cogeneration does not make economic sense in every situation, but it can provide important cost savings to manufacturing plants, and commercial and other facilities. These savings potential exists where there is a significant need for thermal energy and where escalating energy costs comprise a major portion of production or operating budgets.

The greatest potential for cogeneration is represented in five major sectors of the economy: food, pulp and paper, chemicals, petroleum refining and primary metals. But increasingly these industries are being joined by banks, restaurants, hotels, schools, hospitals and other institutions. Skyrocketing energy costs in recent years have sparked resurging interest in the inherent efficiencies and substantial potential of cogeneration technologies, leading to projections that, if a stable and certain tax environment is maintained, by 1995 as much as fifteen percent of the total electricity generated in the U.S. will be generated by cogeneration systems.

Treasury II Would Create a Tax Bias Against Cogeneration

The President's Tax Reform Proposal (Treasury II) would replace ACRS with a new depreciation method -- the Capital Cost Recovery System (CCRS). Under CCRS, business assets would be classified in one of six CCRS categories, and would be assigned annual depreciation rates ranging from 55 percent per year for property in Class 1 to 4 percent for property in Class 6. Each class would also be assigned a specified depreciation period, ranging from four years for Class 1 to 28 years for Class 6.

Electric generating equipment initially would be placed in Class 5, and would be assigned a 17-percent annual depreciation rate and a ten-year depreciation period. Cogeneration systems would be treated as electric generating equipment, even though 70 to 80 percent of the output of the typical system is thermal or mechanical energy and not electricity. By comparison, most other industrial equipment, with which cogeneration systems must compete for investment dollars, would be assigned to Class 4, with a 22-percent annual depreciation rate and a seven-year depreciation period.

Members of the Coalition are concerned because Treasury II would eliminate the relatively level playing field for cogeneration investment which exists under current law. Today, tax benefits are not a consideration in choosing between cogeneration systems and other unregulated investments, including conventional thermal energy production equipment. A manufacturer or other potential investor may therefore choose the energy system which best meets its needs, without fearing that it will, in effect, be faced with a tax penalty. By contrast, Treasury II would build into the Internal Revenue Code a bias against cogeneration because it would place most items of capital equipment in depreciation Class 4, while categorizing cogeneration systems less favorably, in Class 5. Such a bias is unsupportable as a matter of tax, economic and industrial policy.

The proposal is particularly unfair because, under Treasury II, certain pieces of equipment standing alone would be treated differently, and more favorably, than they would be treated when integrated into a cogeneration system. Specifically, boilers and other combustion related equipment, if independently installed for certain industrial or commercial applications, would qualify as Class 4 property. However, the same equipment would be considered Class 5 property if included as components of a cogeneration system.

Treasury apparently is struggling to fit the depreciation method more closely to economic realities, but that is not the outcome of the proposed CCRS treatment of cogeneration. For example, in examining investments in cogeneration equipment it is important to keep in mind that a cogeneration facility is not an independent piece of equipment, but is rather a system, with one of its key components being the waste heat recovery boiler. Some of the components making-up the complete system typically have a shorter life than an industrial boiler (such as the waste heat recovery boiler, water treatment plant, steam turbine condenser, cooling tower and components), and some have a longer life than an industrial boiler (such as the steam turbine, generator and switchgear).

On the average, a cogeneration system over the period of its useful life will require more maintenance, replacement parts, substitutions and repairs than an industrial boiler. While an industrial boiler usually produces saturated or low pressure steam and operates under a rather well-controlled environment, a cogeneration system's boiler, which harnesses different forms of waste heat, operates under a hostile environment, usually at high steam pressures. The cogeneration system's use of poor quality fuels and operation at higher pressures tends to shorten the life of the waste heat recovery boiler.

It would be unfair to investors in cogeneration systems if depreciation were to be based on the longest life item of the system (i.e. the electrical generator), as compared to an average life of the components making up the system. If the same logic were applied to an industrial boiler, its useful life would be based on the potentially infinite life of the boiler's trim, platforms and ladders, rather than the quite predictable life of the grate or the boiler's tubes.

The proposed CCRS treatment of cogeneration could be a significant deterrent to the cogeneration industry. Because capital investments are evaluated on the basis of their internal rate of return, using a present value analysis, investment decisions are most heavily influenced by the return during the early years of the investment. Accordingly, the proposed differentation in tax treatment between cogeneration systems and other capital investments would create a significant bias against cogeneration systems, many of which are financed largely through third party investors. Moreover, this bias would not be compensated for by the inflation adjustments built into CCRS, since those adjustments compensate only for inflation, and do not compensate for the real cost of capital over time.

The Coalition feels that, given the critical importance of energy to this country's economic health and national security, the creation of a tax bias against investment in efficient cogeneration systems is highly inappropriate.

The Utility and Non-Utility Distinction Should Be Maintained

Treasury II would place non-utility cogeneration systems in the same depreciation category as projects developed by regulated utilities, even though the investment considerations of regulated and unregulated electric producers are very different. A public utility's investment decisions are dictated primarily by the pattern of electric demand within the utility's service territory. Because regulated electric utilities are guaranteed a return on their investment, the tax consequences of their investments do not play nearly as significant a role in utilities' investment decision-making as they do in the investment decisions of unregulated companies, which must compete with other unregulated investments for capital. Because of this difference, electric utilities have traditionally been assigned a lower depreciation rate than nonregulated electric producers.

Under current law, cogeneration systems are included in the five-year ACRS category, while public utility generating equipment is included in the ten- or fifteen-year ACRS categories. Cogeneration system users believe that this distinction in treatment is appropriate and must be maintained. Unregulated cogeneration systems, which are exposed to the same entrepreneurial risks as other business investments, should continue to be accorded depreciation treatment comparable to that accorded other unregulated investments. They should not be treated like regulated utility investments. Accordingly, the Coalition urges the Committee to revise the proposed Capital Cost Recovery categories to include cogeneration systems in Class 4 rather than Class 5.

Conclusion

Members of the Coalition are encouraged that the Administration has recognized the special importance of energy production to this country, and the Coalition agrees that national security and economic development considerations demand that the Internal Revenue Code continue to be used to encourage domestic energy production. Treasury II, however, fails to give adequate consideration to cogeneration and would actually bias the Code against cogeneration, thereby defeating the goal of tax neutrality. We urge the Committee to correct this imbalance as it considers the various options for tax reform, and to provide needed encouragement for all forms of domestic energy development.

The members of the Coalition appreciate the opportunity to submit these written comments. We recognize that the Finance Committee has a herculean risk in front of its as it evaluates the various options for tax reform. The Coalition is prepared to work with the Committee in any appropriate way to ensure that issues affecting cogeneration are fairly and appropriately addressed.

BEJ3/VA.102

WRITTEN TESTIMONY
REGARDING
PRESIDENT REAGAN'S
PROPOSALS FOR COMPREHENSIVE TAX REFORM

FOR THE
UNITED STATES SENATE COMMITTEE ON FINANCE
HEARINGS OF
OCTOBER 3, 1985

PRESENTED BY
THE TAX TASK FORCE
OF
THE COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS

OCTOBER 15, 1985

I. THE CNMI APPROVES, IN PRINCIPLE, PRESIDENT REAGAN'S PROPOSAL FOR REFORM OF THE "MIRROR" TAX SYSTEM.

The Tax Task Force of the Commonwealth of the Northern Mariana Islands offers the following observations and comments in general support of President Reagan's Tax Reform Proposals ("Treasury II", or simply "Proposals") in its treatment of the Commonwealth under Chapter 15.05.

As you may be aware, the CNMI has been corresponding and meeting with various staff members of the Department of the Treasury for approximately two years in order to iron out various technical matters in connection with Treasury's proposed U.S.- Northern Marianas Tax Coordination Bill. The tax regime to be substituted for the present "mirror system" under the Coordination Bill has been approved, in principle, by the CNMI Tax Task Force, both houses of the legislature, and the Governor, as well as by the CNMI electorate. Our last meeting with Treasury took place in late April of 1985, and left only very few substantive issues unresolved.

We were therefore very pleased to learn that the Administration's tax reform package contains in Chapter 15.05 a proposal for the repeal of the mirror system presently in force in the CNMI. This proposal appears to be, at least in basic outline, very similar to the Coordination Bill. We were informed by Treasury staffers as late as August of 1985 that no drafting had yet been done on Sec. 15.05 of the Administration's Proposals, and that when drafting was begun, our Coordination Bill might well form the basis of any proposed statutory language.

The CNMI has been actively pursuing the possibility of reforming the mirror system for a variety of reasons, the main ones of which are outlined below; and for the same reasons the CNMI now supports, in principle, the Administration's reform proposals as outlined in Chapter 15.05 of Treasury II. Unconditional CNMI support of the Proposals will be forthcoming at such time as the Proposals are sufficiently fleshed out so as to satisfy CNMI concerns regarding possible complications and disadvantages potentially inherent in the Proposals in their present form.

The CNMI supports a major reform of the current mirror system for much the same reasons as are behind the current Administration Proposals. The rationale behind those Proposals in general is that the current IRC system, even when viewed from the perspective of a mainland taxpayer, is unfair, unduly complicated, and an impediment to economic growth. (Treasury II, Summary p. 1-2). These problems are magnified manyfold when the IRC is implemented as a territorial income tax in a jurisdiction with very different economic and social problems than those present in the mainland United States.

The IRC, with its many complexities, was designed to tax income in the highly developed U.S. economic setting, and is, as a result, wholly inappropriate for the island economy of the CNMI. The possessions in general, and the CNMI in particular, need to be able to develop their own tax systems in order independently to pursue local development policies, and to assume greater control over their own economic welfare. Note, for example, the myriad IRC provisions which grant special tax benefits for favored types of investment activities, such as investments in farming and natural resource development. To the extent that provisions such as these are at all meaningful to Commonwealth taxpayers, they would necessarily involve offshore investments outside of the CNMI, and thus run counter to the established Commonwealth policy of encouraging on-island investment in order to boost the local economy, provide jobs for residents, and enhance the island's potential for attracting tourists.

It should be borne in mind, in this regard, that the CNMI is located in the far pacific region, 1400 miles south of Tokyo, and thus competes for foreign investment capital with the countries of Asia, most notably Hong Kong, the Philippines, and Taiwan. Its tax system must therefore be such as can attract capital, even when measured against the tax systems of those countries. When deciding upon the proper tax system for the Commonwealth, we should also not lose sight of the favorable tax structures accorded by the United States to other Pacific island nations, such as the system presently in place in American Samoa, and the highly advantageous system proposed for the Marshall Islands and the Federated States of Micronesia, under the Compacts.

In addition, the CNMI, to attract such foreign investment, must be able to guarantee potential investors that its tax system is stable, and will not radically change because of changes in the tax system of the United States. The Reform Proposals would in general promote the fiscal autonomy of the CNMI, and allow it to develop a tax system suited to the economic environment in which it is located, and suited as well to its individual revenue needs and administrative and enforcement resources. (See Treasury II, p. 425-6).

It can be argued that any net income tax system, such as the IRC, is not at all suited to the almost 100% import economy of the CNMI. Virtually all goods sold in the Commonwealth are produced or manufactured elsewhere, to be imported and sold or used locally. Under a net income tax system, it is very easy for foreign producers and manufacturers to source the bulk of their earnings offshore and thus avoid any substantial tax liability to the Commonwealth. There are methods of taxation, such as the "unitary method" in effect in California and elsewhere, designed to overcome this problem. Under the mirror, however, the Commonwealth is forced to rely solely on reallocations of income under IRC Sec. 482, which is at best a very cumbersome and inefficient procedure, involving enormous administrative time and effort. The best and most efficient solution to the problem is most likely a gross receipts tax, which avoids all allocation problems by completely abandoning the concept of "net income".

The mirror system, in particular, is a poor choice of tax regime for the CNMI. Under the mirror, any and all amendments to the IRC, as well as all judicial precedents and IRS rulings and regulations, etc., automatically become the law in the CNMI, in spite of the fact that very few, if any, of those amendments, rulings, etc., are drafted with their mirror effects in mind. (It should also be borne in mind that information regarding both proposed and actual IRC changes are slow in being made known to CNMI taxpayers, and that ongoing training sessions and materials for the use of CNMI tax administrative personnel are likewise not readily available). The result is that the mirror system as a whole is very complex and ambiguous in many particulars, making it very difficult both to administer and to comply with, as well as providing many opportunities for tax avoidance or outright evasion. (See Treasury II, p. 426).

In addition, IRC amendments which are beneficial on the mainland can become disastrous when mirrored into the CNMI context. An excellent example of this are the rate reductions and other related rules of Treasury II itself, which while perhaps revenue neutral with respect to mainland taxpayers as a whole, would result in a drastic reduction of total tax revenues collected in the CNMI, due to the radically different mix of high vs. low income taxpayers and individual vs. corporate tax receipts in the CNMI. (See Treasury II, p. 426).

Chapter 15.05 of the Administration Proposals is for the most part, of course, couched in very general terms, which makes it impossible to tell exactly to what extent the proposal may diverge from the regime contemplated by the proposed Coordination Bill and already approved in principle by the relevant CNMI authorities. It nonetheless appears that several features of the Administration's Proposals do so diverge, with potentially undesirable consequences for the economy of the CNMI and for CNMI resident taxpayers.

The remaining sections of this document consist of a short summary delineating the Commonwealth's position, as well its main concerns, regarding the proposed reform of the mirror system in the CNMI, including (1) the overall philosophy underlying any such modification, (2) possible shortcomings of Treasury's proposed Coordination Bill, and (3) apparently disadvantageous divergences between the Coordination Bill and the Administration's reform proposals. Please note that our comments touch upon only the most salient of the many problems inherent in the complete substitution of a new tax regime for the one currently in place. We trust that we will be provided the opportunity to present further and more detailed comments and suggestions as the Reform Proposals progress through Congress, most particularly when drafting is actually begun.

We thank you for your time and attention to these matters of utmost concern to the Commonwealth, and look forward to working with you in devising a tax regime consonant both with the demands of a unified and coherent federal system and with the local concerns of the Commonwealth of the Northern Mariana Islands, a far-off member of the American political family.

II. CNMI CONCERNS REGARDING THE PROPOSED REFORM OF THE MIRROR SYSTEM.

A. GENERAL IMPLEMENTATION PHILOSOPHY AND APPROACH.

The main purpose of the proposed reform of the mirror system is to free the CNMI from the burdens of an externally imposed tax system of inordinate complexity, a system which was, in addition, never designed to be consonant with local conditions. From the point of view of the Commonwealth itself, this means obtaining autonomy over the local tax system so as to implement a system which will be fair and simple to enforce, and which will also be such as to attract investment capital. From the point of view of local taxpayers, it means being subject to a system legislated by their own elected representatives, a simple system they can understand, support, and comply with, and cause to be changed when necessary, in order to keep it responsive to local economic and social conditions.

It is of overriding importance that any new tax regime not substitute its own set of complexities and inordinate burdens for those presently imposed under the mirror. Unless great care is taken regarding two major areas of concern, the Proposals threaten to do just that. The two troubling areas are (1) the potential application of the IRC foreign entity rules to CNMI residents and legal entities; and (2) the necessity of filing future tax returns with both the U.S. and the CNMI, which raises the problem of devising transitional and other rules to solve the potentially great problem of having to deal with agencies of two different jurisdictions regarding the same transactions and income items.

In order to alleviate these problems, the general philosophy behind any new tax regime for the CNMI must be to minimize the burdens imposed by such regime upon legitimate CNMI residents, while at the same time protecting the US fisc by providing stringent rules governing CNMI residence for IRC purposes, in order to eliminate any possibility of tax avoidance or evasion by US mainland persons.

It must be mentioned here at the outset that there is a grave first-order ambiguity regarding just what sort of tax regime is to be substituted for the mirror under the Proposals. The Joint Committee Pamphlet states that the Proposals would place the CNMI "on a par with American Samoa". (Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS-25-85), July 18, 1985, at p. 99). The regime actually contemplated by the President's Proposals themselves, however, appears to be much closer to that in force in Puerto Rico, as is the regime contemplated by the Coordination Bill. Residents of American Samoa, even if U.S citizens, are treated in many instances under the IRC as though they were non-resident aliens with respect to the United States, and are thus subject to IRC taxation only with respect to U.S. source income. (See IRC Secs. 931 and 932). Puerto Rican residents, on the other hand, are treated as U.S. citizens, subject to IRC taxation on their global income, but are allowed a special exclusion for Puerto Rican source income. (See IRC Secs. 876 and 933). This is a major structural difference, which radically changes any analysis of the two problem areas mentioned above. The remainder of this paper will assume that it is indeed the Puerto Rican model which is contemplated by the Proposals.

1. THE IRC FOREIGN ENTITY RULES.

CNMI residents are, under the "mirror", currently subject to the IRC with respect to their global income. They and any CNMI entities, such as corporations, trusts, and partnerships, that they own, are treated just like U.S. mainland persons and their U.S. corporations, trusts, etc. are treated. The most baroquely complex IRC provisions, on the other hand, are those governing the relationships between U.S. persons and various foreign entities. These do not apply with respect to CNMI residents in their dealings with CNMI entities, just as they do not apply to mainland persons in their dealings with mainland entities. Under the Proposals, those foreign entity provisions would become applicable to CNMI residents, as detailed below. Modification of the mirror would thus mean that CNMI residents would no longer be subject to the complex "mirror" IRC rules now governing all domestic transactions, but, in revenge, would for the first time become directly subject to the most excruciatingly complex set of rules in the Code.

Under the current mirror regime, CNMI individual residents file only one IRC return with respect to their income from all sources. This return is filed with the CNMI, and relieves such individuals from any income tax liability to the U.S. (See Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States of America (Public Law 94-241, March 24, 1976, 90 Stat. 263) (the "Covenant"), and IRC Sec. 935). CNMI corporations must file with the CNMI with respect to their global income, and must, in addition, file with the U.S. with respect to their U.S. source income, just like any other foreign corporations; they are, however, in certain circumstances, not liable for the U.S. 30% withholding tax on passive income (see IRC Sec. 881(b)). CNMI corporations, partnerships and trusts, on the other hand, are treated as domestic entities under the mirror itself, and thus none of the highly complex IRC rules regarding U.S. persons who own foreign corporations (Subpart F, the Foreign Personal Holding Company rules, IRC Sec. 367, numerous information reporting rules, etc.) or make transfers to foreign estates or trusts (IRC Sec. 1491), etc. ("IRC foreign entity provisions"), are applicable with respect to CNMI residents who are shareholders of CNMI corporations, grantors of CNMI trusts, etc.

Under the Proposals, the IRC would become directly applicable to CNMI residents, i.e., no longer as a "mirror" Code. As a result, all the IRC foreign entity provisions would suddenly come into play, even where the "foreign" entity is in fact a local CNMI corporation or trust, and the U.S. person is a CNMI resident. Both the Coordination Bill and Treasury II, apparently, intend to provide a complex set of limited exceptions to these IRC foreign entity provisions. Great care must be taken when drafting these rules, to insure that all foreign entity provisions are neutralized in non-abusive situations, and that any conditions placed upon exemption from the foreign entity rules are, on the one hand, sufficiently precise so as to provide certainty to taxpayers, while, on the other hand, not couched in terms of percentage formulae, the exact outcome of which can be known only after the end of the tax-year. Since the consequences of being subject to the foreign entity rules are so extreme, taxpayers must be absolutely sure during the course of the tax-year that they either will or will not be so subject. Thus the only satisfactory solution is for the applicability of the foreign entity rules to be based upon the overall structure of the entity and its owners, and not based upon the complex interactions of various complicated percentile rules.

In addition, it is very difficult to attempt piece-meal alterations and exceptions to the many varied foreign entity provisions, since they are each triggered by separate complex arrays of conditions and requirements. (See Fishman, Tax Forms for International Transactions (Journal of Taxation, 7/85, p.38), a very recent article outlining some 24 tax forms which would be required to be filed by CNMI residents with respect to "foreign", in this case CNMI, entities and transactions). The necessity of understanding the many complex foreign entity rules, as well as any undoubtedly equally complex exceptions thereto may well prove to be a burden greater than those now imposed on CNMI residents under the mirror. The "cure" of the Proposals may just be worse than the "disease" of the mirror!

We would therefore suggest that very general and easily understandable language be inserted into any reform legislation, as well as into the Covenant, to the effect that under the IRC, NMI entities will not be treated as "foreign" with respect to NMI persons, unless not so treating them will present undue avoidance possibilities. The details could then be fleshed out by statute and regulation. One possibility is as follows:

> "In order to assure that no new burdens will be imposed upon a CNMI resident individual because of the foreign and international tax provisions of the Internal Revenue Code, no filings or returns, whether informational or otherwise, shall be required of any bona fide CNMI resident with respect to a corporation or other entity formed in, or under the law of, the CNMI or Guam, unless such corporation or other entity is formed or availed of for the purpose of avoiding the income tax with respect to such CNMI resident".

In order to prevent US mainland residents from taking undue advantage of this rule, the US and the CNMI would each implement stringent interlocking legislation governing qualification as a CNMI resident. In addition, the US could require certification of CNMI residence as a precondition to obtaining CNMI resident classification, and could provide substantial penalties for falsely claiming such residence.

2. FILING REQUIREMENTS: JURISDICTIONAL CONFLICTS.

As outlined above, under the current mirror regime, CNMI residents file all their income tax returns with the government of the Commonwealth, and are thereby relieved of any direct obligation with respect to the filing of returns or the payment of income taxes to the United States. (See Covenant Sec. 601(b) and IRC Sec. 935). Under the Proposals, a resident of the Commonwealth would be required to file a U.S. return and pay U.S. taxes if he receives above a threshhold amount of U.S. and/or foreign source income. Thus a resident would, in certain circumstances, have to report and pay tax to both the U.S. and the CNMI. Double taxation would, in theory, at least, not be a problem, because of the U.S. Foreign Tax Credit rules (IRC Secs. 901 through 904). In fact, of course, double taxation is always a potential problem whenever the source of a given income item is subject to independent determination by two taxing jursidictions, and the problem is exacerbated by the ambiguities inherent in the present U.S. rules governing source of income.

The situation under the Proposals would thus be very similar to that obtaining on Guam before the passage of reform legislation in 1972, i.e., before the "one-return rule" of IRC Sec. 935, which was passed precisely in order to eliminate the burdens and complications of dual filing. (See House Report (Ways and Means Committee) No. 92-1479, Oct. 2, 1972 (To accompany H.R. 14628), pp. 5401 et. seq.). We should not lose sight of Guam's disastrous experience with dual filing, but should rather now benefit from that experience, and thus be very hesitant to implement a tax regime based thereon.

a. The Preferred Solution.

The Commonwealth has since 1979 administered and enforced the IRC with respect to the non-local source income of its residents. There is no apparent need to move such administration to the mainland at this time merely because of the contemplated reform of the mirror system. Commonwealth taxpayers are much more apt to be satisfied with, and thus comply with, the tax regime ultimately imposed, if administration and enforcement remains with local taxing authorities. Residents of the CNMI, it must not be forgotten, have no voting representative in Congress, and cannot themselves vote in U.S. presidential elections. The spectre of "taxation without representation" is, however, at least very much attenuated, to the extent that the taxes imposed from a distance are nonetheless administered and collected at home, by local officials who are of necessity themselves responsive to local conditions and the particular circumstances and needs of the local population.

It does not appear that any overall U.S. policy decision has been made to end all administration and enforcement of the IRC by the territories. Note, in this regard, that under the Proposals, the Virgin Islands would continue to administer and enforce the IRC tax on the non-local income of its residents. (Proposals, p.428). Indeed, it is difficult to see just what benefit is to be obtained for the United States by the assumption of these administration and enforcement responsibilities. The United States has in fact assumed such responsibilities with respect to the non-local source income of Puerto Rican residents; yet, to the best of our knowledge, no statistics are kept regarding either the number of such returns processed, nor the amount of revenue generated by such U.S. enforcement. If, in fact, no such records are kept, the Treasury and IRS must deem the retention of such jurisdiction to be a matter of no great significance. In these circumstances, jurisdiction over the administration of taxation on non-local source income should remain with the CNMI even after reform of the mirror system.

In addition, of course, the removal of local jurisdiction over the administration of taxation on non-local source income would tend to discourage wealthy foreign individuals from moving to the Commonwealth, would needlessly result in the loss of jobs for those residents now employed in such administration, and could also be perceived as gratutitously diminishing the power and prestige of the local taxing authorities.

In the event that administration and enforcement responsibilities with respect to IRC taxation of non-local source income are retained by CNMI taxing authorities, as we are proposing, nonetheless such responsibilities with respect to prior mirror years would remain with the United States with respect to return years of individuals who were not CNMI residents during those mirror regime years. This would eliminate any tax avoidance possibilities for such U.S. persons, and at the same time would not cause undue complications for them, since they would not be subject to the administrative processes of two separate jurisdictions with respect to the same filing years and items of income.

b. Transitional Problems.

In the event that administration and enforcement of the IRC with respect to the non-local source income of CNMI residents does nonetheless not remain in the control of the local taxing authorities after the reform of the mirror system, certain explicit jursidictional and other rules will be necessary, in order to assure that the change-over does not create transitional problems, in addition to the ongoing problems discussed in the preceeding paragraphs.

As proposed above, jurisdiction over taxes and returns with respect to prior mirror regime years should remain an administration and enforcement responsibility of the jurisdiction with which such returns were originally properly filed under the mirror, i.e., with the taxpayer's jurisdiction of residence during the relevant mirror years. Audit and other enforcement duties with respect to such years must remain the responsibility of the officials of the then residence jurisdiction, in order that such residents during the mirror years need not now deal with two separate taxing authorities regarding mirror years' returns and income items.

All tax attributes, such as basis, NOL's, etc., should be carried over from mirror to non-mirror years, in spite of the change in administering authority. This must be done in order to make possible at all the first year's filing with U.S. taxing authorities, and in order to preserve the constitutionally mandated rules contained in the start-up provisions of the Northern Marianas Territorial Income Tax, the Commonwealth's 1985 implementation of the IRC as a mirror code. One possible statutory approach is as follows:

> "Full faith and credit shall be extended to all statutory law, judicial decisions, and administrative rulings of the jurisdiction of residence with respect to transactions and events occurring in taxable years ending prior to the effective date [of the new tax regime]."

B. OTHER SPECIFIC CONCERNS.

1. EFFECTIVE DATES.

Treasury II, at p. 431, provides that while the "conforming changes" to U.S. law would be effective on 1/1/86, the mirror code currently administered by the CNMI would remain in effect "until and except to the extent" that the CNMI acted to amend such mirror code. The meaning of this language is very unclear. Would the various current mirror coordination rules, such as IRC Sec. 935 and 7654, remain in effect until the Commonwealth so acted? (Treasury II, at p.429, states that the CNMI "could adopt a mirror system as its local law, if desired", as is currently the case in American Samoa. This seems to mean that the current US coordinating rules would be repealed immediately). Could the mirror system then be retained indefinitely, should the Commonwealth so choose? Or would the U.S. side of the mirror be changed immediately, leaving the Commonwealth with the worst of both worlds, a purely local tax consisting of its current IRC implementation, but without the benefits of the one-return rule of IRC Sec. 935 and other associated U.S. provisions, and with administration over non-local source income having been assumed by the relevant United States authorities? What does it mean for the mirror to remain in effect "to some extent"?

The answers to these questions are very important. We would suggest that these uncertainties be resolved by statutory language to the effect that the CNMI mirror will remain in place, exactly as at the present time, until such time as the CNMI itself acts to replace the local IRC with a system of its own choice; but that until then, the mirror together with all current related U.S. law shall remain in effect. The presence of such an effective date rule would make it much easier for the CNMI to support the proposed legislation in spite of remaining ambiguities as to the ultimate workings of the proposed tax regime, since the Commonwealth would then not be faced with the difficult choice between a system whose effect on its residents is disliked, but at least fully known, and a system of which it in principle approves, but the exact workings of which are unclear.

2. SOURCE AND RESIDENCE RULES.

The operative substantive rule of the proposed reform is that a CNMI resident will have to file an IRC return only with respect to non-local source income, i.e., U.S. and foreign source income. The key determinations which will control the operation of this rule involve the residence of the individual and the source of his various items of income. The effect of the proposed regime on CNMI residents is ambiguous and uncertain precisely to the extent that the rules governing source and residence are ambiguous and uncertain.

We therefore recommend that the relevant source and residence rules be fixed at the outset, and that the following language or principles be embodied in any reform legislation, as well as placed into the Covenant:

> "For purposes of the above exclusion (i.e., the exclusion from income of the CNMI and Guam source income of CNMI year-end residents),
>
> (1) The source any item of income shall be determined under the principles of the U.S. source rules as embodied in Chapter 15.02 of the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, May 29, 1985;
>
> (2) the source of a dividend received from a corporation organized in, or under the law of, the CNMI shall be determined under the principles of the U.S. source rules, as embodied in IRC Sec. 861(a)(2)(a), as in effect on January 1, 1985; and
>
> (3) the residence of an individual shall be determined under the principles of the U.S. residence rules, as embodied in IRC Sec. 7701(b), as in effect on January 1, 1985."

3. THE AMOUNT OF REVENUE TO BE RAISED LOCALLY.

Both the Proposals and the Coordination Bill require that the Commonwealth raise at least a certain amount of revenue through its local tax system. This amount is defined as "at least as much revenue as the mirror system currently implemented". (See Proposals, p. 429). As it stands, this formula would be meaningless in the CNMI, if, as appears likely, the CNMI implements a gross revenue tax system to take the place of the mirror. With only a gross system in place, the records will be lacking from which to make a reconstruction of the amount which would have been collected under a hypothetical mirror. Even if the records were available, such a computation would be exceedingly costly, time-consuming, and imprecise.

The CNMI in fiscal 1983-84 collected a total of 14.3 million dollars in revenues from its Business Gross Revenue Tax, its Individual Gross Wage and Salary Tax, and its various excise taxes. This represents 5.55% of total Island Gross Receipts, as compared with the 3.85% of total U.S. gross receipts collected by the United States under its individual and corporate income taxes and its various excise taxes.

The following language provides for a reasonable and easily administrable test based on those comparative figures:

> "The CNMI shall collect under its gross and/or net income and excise taxes at least as much revenue, when expressed as a percentage of total gross island revenues, as the United States collects under its net income and excise taxes, when expressed as a like percentage."

4. DIVERGENCES BETWEEN THE PROPOSALS AND THE COORDINATION BILL

The Proposals appear to differ from the Coordination Bill in several important and disadvantageous respects. There follows a brief explanation of the apparent divergences and their effect.

a. FOREIGN TAX CREDIT.

The Coordination Bill specifically provides that the local CNMI taxes will qualify for the U.S. foreign tax credit. This is especially important because the CNMI imposes, and will likely continue to impose, gross income taxes, which, at least arguably, do not so qualify under present U.S rules. The CNMI should be given sufficient flexibility to impose gross taxes if those are locally desirable, without losing the benefits of the foreign tax credit, without which mainland persons will be hesitant to invest in the Commonwealth. The Proposals, at p. 430, state that local taxes will qualify only if they otherwise qualify under the applicable regulations. Any new law should follow the rule of the Coordination Bill, and not that of the Proposals.

b. FILING REQUIREMENTS: AMOUNTS.

The Proposals' filing rules apparently do not track the tax liability rules. Whereas a CNMI resident would "be required to file a U.S. return if he received U.S. or foreign source income", "he would be required to pay a tax only if he received more than a threshhold amount of income, including U.S. source income, from sources outside the CNMI and Guam". (See Proposals, p. 429). The threshhold amount referred to equals the zero bracket amount plus any personal exemption amounts. The filing rules should track this liability rule, as in the Coordination Bill.

c. ANTI-FINANCE SUBSIDIARY RULES.

The Proposals, at p. 430, change the anti-abuse requirements of present IRC Sec. 881(b) for the exemption from the U.S. 30% withholding tax on certain passive U.S. income of foreign (including CNMI) corporations. (The Coordination Bill also changes those rules albeit in a different manner). The 25% percent foreign person rule is fair and completely acceptable. The 65% active trade or business requirement appears to serve no real purpose, and would prevent a CNMI investment company 100% owned by CNMI and U.S residents from making passive U.S. investments, even though each individual shareholder could make such investments free of the 30% tax. This prong of the test should be modified or abandoned.

The third prong of the test, that the CNMI corporation not be a conduit for payments to non-resident persons, is very loosely worded. (It appears, for example, to impose the tax if the corporation makes dividend payments to U.S mainland persons). Any actual statutory language must be very carefully worded to insure that such a corporation is allowed to make payments for goods and services to foreign persons, without jeopardizing its exemption. The CNMI is a totally import dependent economy. Virtually all goods sold or consumed in the Commonwealth are produced elsewhere, and much is purchased from sellers in foreign countries. Hardly any CNMI corporation engaged in a trade or business could afford to gamble on U.S. passive investments, because legitimate business payments to foreign persons could then trigger the 30% withholding tax.

d. CONTROLLED FOREIGN CORPORATIONS.

Proposals Chapter 12.05 would replace the current Possessions Tax Credit with a wage credit. The CNMI takes no position on the proposed changes to IRC Sec. 936, except to note that the benefits of present Sec. 936 could be very helpful in attracting mainland capital to the Commonwealth. The CNMI does, however, take the position that whatever changes are made to Sec. 936, nonetheless IRC Sec. 957(c), the exemption from Controlled Foreign Corporation ("CFC") status for certain possessions corporations, should not be repealed. The two provisions appear to be only superficially related, and the CFC exemption is potentially very useful in attracting legitimate U.S. business operations to the Commonwealth.

STATEMENT OF
JEROME J. MCGRATH
ON BEHALF OF THE
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
BEFORE THE COMMITTEE ON FINANCE
OF THE
U.S. SENATE

OCTOBER 3, 1985

Mr. Chairman and Members of the Committee:

My name is Jerome J. McGrath. I am the President of the Interstate Natural Gas Association of America (INGAA), and it is in this capacity that I appear before the Committee today. INGAA is a non-profit national trade association whose membership consists of the major interstate natural gas transmission companies in the United States. INGAA's members account for approximately 90 percent of the natural gas that is transported and sold in interstate commerce. All of our member companies are subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC) as mandated by the provisions of the Natural Gas Act (15 U.S.C. 717, et seq.)

Natural gas constitutes approximately one-fourth of the total energy consumed by our economy. The features of safety, cleanliness, and reliability make gas a desired fuel. In addition, when burned, gas releases virtually no pollutants and, thus, poses no environmental threat. Ninety-six percent of the gas consumed in this country is produced domestically and, therefore, is invulnerable to foreign embargo. Gas supplies about 40 percent of the total energy requirement of the U.S. industrial sector. As you can see, gas has occupied an essential role in our society. We feel confident that gas can continue to maintain its important place in our energy picture. To do this, however, it is essential that the tax treatment accorded our industry be such as to encourage rather than discourage the substantial investments needed to meet this challenge.

Fundamentally, the natural gas industry believes that the goal of tax reform should be to simplify the tax code and to promote equitable treatment of all taxpayers. Accordingly, INGAA supports the concept of tax reform and the general approach to tax reform embodied in the President's reform proposal. We recognize that lowering tax rates and modifying deductions and credits are important steps to take in any effort to significantly reform the tax code, nevertheless we would voice the following concerns:

1. Normalization - In order to retain any part of the benefits from a number of the tax changes that have been proposed, regulated utilities need to "normalize" these benefits. Current law mandates that deferred taxes attributable to depreciation be normalized and we note that the President's proposal states that the new Capital Cost Recovery System of depreciation would contain normalization rules comparable to the current ACRS system. INGAA urges the Committee to include language in a tax reform bill that would continue the mandatory normalization of depreciation and to extend the normalization requirement for corporate rate reduction (to the extent not reflected in additional taxes resulting from the depreciation recapture proposal) and for the proposed dividends-paid deduction.

With respect to depreciation, tax normalization is an accounting method, widely adopted for public utility ratemaking purposes, by which regulated industries are able to evenly spread out the tax benefits from investment in plant and equipment to consumers and the utility over the life of the asset reflected for financial statement purposes. The benefits of tax depreciation are defined as the excess of accelerated depreciation over straight line depreciation. The tax effect of the amount so determined is recorded in a deferred tax account and deducted from the utility's rate base in the determination of rates charged to customers. The lower rate base results in a reduction in rates benefitting all ratepayers evenly over the life of the property and not just benefitting those who are customers during the shorter recovery period over which the property is depreciated for tax purposes. For this reason, INGAA supports the continuance of mandatory normalization of accelerated depreciation in the event the CCRS system is adopted.

For similar reasons, INGAA supports appropriate normalization rules pertaining to the treatment of accrued deferred taxes in the event of a reduction of the corporate tax rate from 46 percent to 33 percent. Regulated utilities generally collect taxes from consumers as part of the rates they charge. The tax has been collected at a 46 percent rate and, to the extent timing differences occur, the excess over the current liability has been recorded in a deferred tax reserve account until the tax becomes due. If the corporate rate is reduced, it is obvious that too much has been collected. Through the depreciation recapture provisions, amounts relating to 1980 and subsequent years are paid to the government as additional taxes. Amounts relating to years prior to 1980 presumably would be refundable to the consumers.

However, it would not be fair to return these excess deferred taxes only to those who happen to be consumers at the present time since for many this would be a windfall. In addition, if these amounts are required by utility commissions to be returned to customers in a lump sum or over a short period of time, many utilities would be unable to comply because of the lack of adequate cash flow. Accordingly, we strongly support the inclusion of legislative language to "normalize" the return to consumers of pre-1980 excess deferred tax reserves over an appropriate period of time.

2. Transition Rules - INGAA does not support the elimination of the investment tax credit or the Alternative Energy Production Credit. Nevertheless, if the Committee should find it necessary to modify or repeal these provisions, INGAA suggests that a transition rule be provided that would continue to allow existing credits and also deductions to be utilized when construction has commenced or if, pursuant to a binding contract, substantial expenditures or other commitments have been incurred in reliance on such tax benefits. A similar rule should apply when the taxpayer enters into a contract for the sale of a product which obligates it to construct a facility. Further, a transition rule should provide relief in situations where projects are proposed and substantial sums have been expended for preliminary work but where final approval is pending before state or federal regulatory agencies. We strongly urge that

there be transition rules that recognize the unique problems facing the gas industry, whose construction projects are not only of long duration, but in addition are subject to very lengthy regulatory approval procedures. Taxpayers should not be denied tax benefits on planned projects when the economic feasibility of the project depended on the tax benefits in the law when the project commenced.

Many of INGAA's member companies have entered into contracts to provide service, to construct plant or equipment or to make other investments that would not be economically feasible under the tax code as envisioned by the reform proposal. For example, after years of planning and feasibility studies, one of INGAA's member companies expects to enter into contracts to construct a number of cogeneration and low-BTU coal gasification plants in 1985. Because these facilities will often incorporate new or developing technologies, the economics of such projects are less than certain. However, the economics of each facility will depend heavily on the assumption that the tax benefits of ACRS, ITC and in some cases the Alternate Energy Production Credit will be available to the project when it is placed in service. The elimination or substantial reduction of such tax benefits will destroy the economic feasibility of each of these planned projects and result in substantial losses for projects that are underway or under contract.

Furthermore, given the large scale of many of the construction projects common to regulated utilities, many projects could not be placed in service by the end of this year and therefore would not qualify, under the President's proposal, for the tax credits and other tax benefits assumed to be available when the construction contract was entered into or when self-construction was begun.

3. Depreciation - The regulated natural gas industry supports the main thrust of the Capital Cost Recovery system as proposed, provided that, as previously stated, appropriate legislative language is included to continue the mandatory "normalization" of deferred taxes attributable to depreciation. In addition, the industry feels that congeneration plants, which were treated as five year property under ACRS, would be improperly included under the Administration's Proposal in CCRS Asset Class 5, which has a recovery period of ten years. We believe that cogeneration plants should be specifically identified as "other electrical equipment" and included in CCRS Asset Class 4. In addition, we believe that the CCRS plan should be made more workable with a mid-year convention for the year the asset is placed in service.

A. Multiple Recordkeeping -

Despite our support of CCRS, we believe that the President's proposal does not fully recognize the burden being placed on taxpayers to maintain multiple sets of depreciation records. Under the proposal, corporations would be required to maintain depreciation records under pre-1981 methods, ACRS, CCRS, RCRS, earnings and profits depreciation, and straight-line depreciation (for real estate) in order to compute taxable income, excess depreciation for the windfall tax, and the alternative minimum tax. The proposal should be improved by requiring all depreciation records to be kept with reference only to pre-1981 methods, ACRS, and CCRS. References to RCRS (for minimum tax purposes) or other new methods of depreciation should be eliminated.

B. Recapture of ACRS Depreciation -

INGAA understands the Treasury Department's theory underlying the proposal. A recapture tax, especially when imposed over a three year period, would significantly reduce cash flows required for reinvestment by capital intensive industries such as regulated utilities. Such a tax, if absolutely needed, should be spread over a longer period of time. The financial feasibility of past and current investments in plant and equipment are based in part on the benefits of ACRS. A longer collection period would allow the tax to be imposed while lessening the detrimental effects on the industry.

4. Minimum tax - Our industry does not oppose the proposal to enact a new minimum tax, which is intended to affect the timing of a corporation's tax liability. However, there is one important aspect of the President's minimum tax proposal with which we take exception. The proposal, in addition to affecting the timing of tax liability, would over a period of time, increase the corporation's effective tax rate and total taxes paid above the maximum proposed rate of 33% if the corporation is subject to the minimum tax. This situation arises because items such as rapid depreciation accelerate deductions. A minimum tax would force corporations with an excess of such deductions to accelerate payment of taxes earlier than such taxes would otherwise be owed. However, the proposal does not reflect the early payment of tax, via the minimum tax, at the time the regular tax on the

same items would normally come due because the deductions have run out. As a result the proposal creates double taxation.

In order to eliminate this double taxation, INGAA proposes that corporations be allowed to take as a credit against their regular tax in subsequent years the amount of any alternative minimum tax that may have been paid in prior years. This approach is consistent with the Administration's own 1982 minimum tax proposal.

5. Intangible Drilling Costs - INGAA supports the retention of the current tax treatment of intangible drilling costs. Given the high degree of risk inherent in drilling for gas or oil, it is clear that appropriate incentives must be available to encourage the development of new energy supplies. It is INGAA's view that any radical change in the tax treatment of these costs would lead to significant reductions in the domestic output of gas and oil and would be contrary to our announced goal of energy self-sufficiency.

6. Employee Benefits - Mr. Chairman, we are aware that a number of witnesses have mentioned the proposals to modify the taxation of employee benefits so we will not discuss these proposals in detail. Let me say that since 1981 there have been three separate bills enacted making broad changes in this section of the tax law. We are concerned that any additional changes would only exacerbate the confusion that already exists in this complex area. Should the Committee nevertheless decide to make yet more changes with respect to employee benefits, INGAA would oppose any change that would discourage our

employees from helping to provide for their own retirement and the support of their families.

I thank the Committee for this opportunity to submit our views for your consideration.

LIA
LIGA de INSTITUCIONES de AHORRO de PUERTO RICO
PUERTO RICO LEAGUE of SAVINGS INSTITUTIONS
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MARIANO J. MIER
Presidente

TESTIMONY

PRESENTED BY

MARIANO J. MIER,

PRESIDENT,

FIRST FEDERAL SAVINGS BANK

OF PUERTO RICO,

ON BEHALF OF

THE PUERTO RICO

LEAGUE OF SAVINGS INSTITUTIONS,

BEFORE THE

SENATE FINANCE COMMITTEE

OCTOBER 3, 1985

My name is Mariano J. Mier and I am President and Chief Executive Officer of First Federal Savings Bank, Puerto Rico's oldest and largest thrift institution.

It is my great pleasure to appear before you today as President of the Puerto Rico League of Savings Institutions. The League has as its members the island's twelve federally chartered thrift institutions whose combined resources amounted to $4.8 billion, or twenty percent of the total resources of all depository institutions in Puerto Rico.

The purpose of my testimony is to express the utmost concern of our membership regarding certain proposed changes to Section 936 of the U.S. Internal Revenue Code which are contained in The President's Tax Proposal to the Congress for Fairness, Growth and Simplicity dated May 29, 1985, (the "President's Proposals") and in the Summary of Tax Reform Options for Consideration by Committee on Ways and Means dated September 26, 1985, prepared by the staff of the Joint Committee on Taxation (the "Joint Committee Proposals").

The President's Proposals would repeal the current income-based credit of Section 936 and replace it with a complicated wage credit. Corporations currently electing Section 936 corporation status would be grandfathered for a period of five years as to products being "manufactured" on the date of enactment of the proposed change. Qualified possession source investment income ("passive income") earned by grandfathered Section 936 corporations would also be grandfathered for a corresponding five year term.

The Joint Committee Proposals would eliminate the cost sharing option for allocating intangible income which is currently available to Section 936 corporations. Under this proposal, one half of the passive income earned by Section 936 corporations would be subject to full federal taxation.

I should like to state to this Committee in no uncertain terms that the enactment of any of the above described proposals would severely disrupt the island's financial system and would especially jeopardize Puerto Rico's vulnerable thrift industry. Attached to my testimony is a study prepared by Alan T. Udall, First Federal's staff economist, which carefully evaluates the Joint Committee Proposals. Let me set forth the importance of Puerto Rico's thrift industry to the Puerto Rican economy and how Section 936 funds now on deposit with our member associations and savings banks, have fueled their strong recovery from the brink of insolvency.

Though the Puerto Rican thrift industry accounts for only twenty percent of the total resources of all depository institutions on the island, it is the source of fifty percent of all construction loans and of seventy-five percent of all housing mortgages. Lower cost Section 936 funds have enabled thrifts to pass these savings on to Puerto Rican homeowners and to provide them with the opportunity to acquire adequate housing at more affordable interest rates. These homeowners whose per capita income is only one half that of the lowest State of the Union, must bear a cost of living that is between ten and fifteen percent higher than on the mainland. By stimulating the housing industry, thrift institutions have also been instrumental in keeping alive the island's once-thriving

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construction industry, which is the source of employment for a significant portion of our population.

The thrift industry makes significant contributions to other important sectors of the Puerto Rican economy. It has moved swiftly to exercise new lending authority granted under the Garn St. Germain legislation. The industry has become a substantial force in commercial and consumer lending. In addition, the thrift industry holds considerable amounts of the debt obligations of the Government of Puerto Rico, its agencies and municipalities. The thrift industry is a source of direct employment for over 2,000 persons and more than twice that number indirectly. With the help of Section 936 funds, the industry has turned the corner and is on the way to full recovery while contributing significantly to the Puerto Rican economy.

One may ask why Section 936 funds are vital to the thrift industry. The answer lies in a brief recounting of the difficulties encountered generally by the thrift industry in recent years as a result of the high interest rate environment and the effects of deregulation.

Thrifts traditionally lent their funds for long term housing mortgages at fixed rates of interest. This system worked fine for several decades until increasing rates of interest drove the cost of money through the roof. Thrifts began to experience negative spreads between cost of money and return on investments. An imbalance in the maturities of their assets and liabilities further aggravated their problem. They began to bleed themselves dry. Thrifts in Puerto Rico were no different; they also began to experience significant losses. First Federal Savings, the bank of which I am President, sustained losses of $58 million between 1978 and 1982. The Federal Savings and Loan Insurance Corporation provided us with $35 million in assistance in order to keep the institution operating. As you are undoubtedly aware, during this period and even to the present, federal regulatory and deposit insuring authorities have closed, merged or assisted hundreds of banks and thrift institutions throughout our nation as a result of these adverse conditions.

Fortunately, as a result of the adoption of Section 936 in 1976, which allowed electing corporations to derive up to 50% of their income from qualified possession source investments, a substantial pool of so-called Section 936 funds began to accumulate within our financial system. This pool of money initially found its way into very short term deposits with the island's largest commercial banks. However, in order to spread the economic effect of these funds throughout the economy, the Puerto Rican Government enacted regulations designed to force banks and other financial institutions to invest these funds in certain "eligible" activities, one of which is housing. Brokers began to make available part of these low cost funds to thrifts through repurchase agreements. By March of this year, approximately $1.1 billion of low cost Section 936 funds had been made available to the island's twelve thrift institutions through this mechanism.

In addition to receiving these funds through repurchase agreements, thrifts were able to issue longer term debt obligations secured by the Federal Home Loan Bank of New York or the Federal Savings and Loan Insurance Corporation directly to Section 936 corporations at very favorable interest rates. Since 1982 more that $700 million of lower cost, longer term financing has been provided to Puerto Rico's thrift institutions directly by Section 936 corporations. A new program of the Federal Home Loan Bank of New York guarantees deposits made by Section 936 corporations in Puerto Rican thrift institutions. More than $125 million has now been deposited under this program with terms of up to three years.

The effect of this lower cost source of funds on the operations of Puerto Rico thrifts has been remarkable. Unlike the mainland experience, Puerto Rico experienced no failures among its thrift institutions, although three institutions were acquired by healthier associations. The 1.5% to 2% differential between the cost of Section 936 funds and the average cost of funds from other traditional sources represents an additional $18 to $22 million dollars for our industry. In 1984 this differential represented the difference between a net combined profit of $16.3 million and a $5.1 million loss.

In First Federal's case, the availability of substantial Section 936 financing together with federal help and fundamental changes in management policies, have strengthened the institution to the point where it has consistently operated at a profit during the past thirty months. Our institution is the first thrift institution to begin repaying both the principal and interest on the assistance provided by the Federal Savings and Loan Insurance Corporation. The unavailability of Section 936 funds would have made the recovery of our industry in general and of First Federal in particular, that much more difficult, if not impossible.

I would like to turn now to the effect which adoption of either of the changes to Section 936 set forth in the President's Proposals or in the Joint Committee Proposals would have on Puerto Rico's thrift industry.

The elimination of Section 936 as proposed under the President's Proposals would abolish outright the Section 936 funds market. No new Section 936 financings would be possible for thrift associations which would be forced to replace these funds with higher priced deposits or loan advances from the Federal Home Loan Bank. Taxation of one half of the passive income as proposed under the Joint Committee Proposals would produce the same result with one aggravating factor. Most of the Section 936 financings contain an "adverse tax law change" clause in their indentures which allow the noteholders to put the obligations back to their issuers in the event of such an adverse tax law change. Taxation of one half of the passive income would trigger such a clause in many of these financings. If enough of the outstanding notes are put back to the issuers, the strain on the liquidity of our thrifts would force them to turn to the Federal Home Loan Bank or to the Federal Savings and Loan Insurance Corporation for assistance. Some institutions may not be salvageable under those circumstances and would force the latter federal agency to liquidate them and absorb substantial losses.

In addition to the potential loss of the Section 936 debt financings, our thrifts would lose other direct Section 936 deposits and repurchase agreements thereby increasing the pressure on their liquidity and solvency. Furthermore, thrifts would face a loss of non-Section 936 deposits as a result of the interest rate war that is sure to ensue as commercial banks, thrifts and other financial institutions rush to replace the loss of Section 936 funds. Commercial banks, 44% of whose deposits are Section 936 funds, can afford to pay higher interest rates on their deposits since the nature of their assets allows them to adapt quickly to changing interest rate environments. Thrift institutions, on the other hand, which have the bulk of their assets in fixed return long term mortgages, will not be able to afford to bear the higher cost of money without incurring a substantial erosion in their earnings or even returning to operating at a loss. In any event, the future for the thrift industry in Puerto Rico, should Section 936 be amended as proposed, would be very bleak indeed.

The ultimate victim of such adverse consequences would be the Puerto Rican consumer. He would be faced with a substantial reduction in the funds available for borrowing, and those would be available only at sharply higher interest rates, perhaps out of his range of affordability. The increased cost of housing funds would similarly put new housing out of reach for many potential homeowners. The already restricted housing industry would be reduced further thereby dealing another potentially fatal blow to the reeling construction sector.

Reduced economic activity may render unprofitable the operation of branches in smaller towns, thus forcing their closing. The contraction in lending would lead to the inevitable retrenching and laying off of personnel within our members.

Current Government of Puerto Rico regulations require depository institutions to invest 20% of their average monthly Section 936 deposits in obligations of the Government of Puerto Rico, its agencies or municipalities. Over $2 billion of such Puerto Rican government obligations are presently held by depository institutions on the island, a factor which has both strengthened the market for said obligations and reduced the cost of borrowing by the island's government. As Section 936 deposits are withdrawn, depository institutions would be free to sell their holdings of Puerto Rican government obligations in order to relieve the strain on their liquidity. The pressure to sell these securities would tend to depress their price hence generating additional pressures to sell in order to avoid further loss. This loss of support would cause a sharp increase in the cost of borrowing by the Government of Puerto Rico. This in turn would probably slow down considerably future expenditures for capital improvements by the Government.

Government utilities such as the Puerto Rico Electric Power Authority, the Puerto Rico Water and Sewer Authority and the Puerto Rico Telephone Company would also be expected to experience reductions in revenues as departing Section 936 companies no longer need their services. These reductions in revenues would further erode the credit rating of Puerto Rican government obligations. As Section 936 companies left the island, municipalities would face a loss in business taxes and a reduction in property tax collections due to the general economic contraction which is sure to follow. These would further strain their capacity to service their obligations and to meet the needs of the rising number of unemployed, which already hovers around 23% of the labor force.

It is not my style to sound like a Cassandra and paint an unrealistically bleak picture. Our members and I genuinely share the belief that the changes recommended by the President's Proposals or the Joint Committee Proposals would unnecesarily wreak great havoc upon our financial industry and would spread despair and hopelessness among the 3.2 million American citizens of Puerto Rico.

I should briefly like to point out two further flaws in the President's Proposals which would produce significant adverse effects on our industry. First, they do not make the proposed wage credit applicable to non-manufacturing operations. This would have the effect of rendering all federally chartered thrift institutions taxable by the federal government. Currently, many of these institutions qualify for the income based credit of Section 936, although they pay taxes to the Puerto Rican government. Taxation by both the federal and Puerto Rican governments would result in higher operating costs for federally chartered thrift institutions and would hinder their ability to compete with locally chartered institutions which are not generally subject to federal taxation.

Second, they would eliminate the special 80/20 rules under Section 861 which allow interest paid to residents of Puerto Rico by federally chartered institutions on the island to be exempt from federal taxation. These rules generally provide that interest paid by a U.S. domestic corporation shall not be subject to federal taxation if the corporation making the interest payment earned not more than twenty percent of its income from sources outside the United States. Because federally chartered thrifts in Puerto Rico are deemed to be United States domestic corporations, interest paid by them would, but for the special rules of Section 861, be subject to federal taxation. The President's Proposals would abolish the special rules thereby rendering federally taxable interest paid to Puerto Rican depositors. I can assure you that if this obvious oversight is enacted into law, there would be a massive shift in deposits from federally chartered institutions to locally-chartered institutions in order for local depositors to avoid federal taxation. It would also force all federally chartered thrifts on the island to convert to locally chartered status.

I would like to close by reminding you that Section 936 has been and continues to be the most effective and successful economic development incentive which the Congress has granted Puerto Rico since the Stars and Stripes first landed on our southern shores 87 years ago. United States citizenship, which was extended to Puerto Rico during the terrible war years of 1917, carries an implied promise of economic improvement for all. Section 936 has made that implied promise a reality for all American citizens of Puerto

Rico. It represents not another federal handout, but a strong development incentive that has provided direct and indirect employment for over one third of our labor force. To dash the hopes of those who have found their livelihood and their future in the hundreds of Section 936 companies which are thriving throughout our island, would deal a cruel blow to their faith in our American way of life. It would send the wrong signal to our neighbors who encircle this emerald Caribbean Sea, who would come to understand that American citizenship is valueless if you happen to live in a poor, desperate island. It would strengthen the hand of our enemies who would stand to gain from our misfortune.

The time has come for this 99th Congress to revalidate the wisdom and generosity shown by the 94th, when by enacting Section 936 it fulfilled the basic promise of American citizenship - the opportunity to forge a better future for all.

Thank you.

FIRST FEDERAL SAVINGS BANK
San Juan, P.R.

THE PROPOSAL TO TAX PASSIVE INCOME UNDER SECTION 936: AN EVALUATION

By
Alan T. Udall

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INTRODUCTION

The last few months have seen a number of new studies on Section 936 of the U.S. Internal Revenue Code, which provides tax exemption to subsidiaries of U.S. firms operating in Puerto Rico. The passive income provisions of this legislation have been largely ignored in this new research.

Now that the staff of the Joint Committee on Taxation has proposed a tax on this income, it is appropriate to examine the pros and cons of maintaining the current tax exemption for passive income. We will show that a number of changes in Federal and local government policies over the last few years have been increasing the effectiveness of this tax exemption as an economic development tool for Puerto Rico. At the very moment when Congress is considering the modification of this provision, it is accomplishing its intended goals more effectively than at any time in the past.

This study will be organized in the following way. Chapter I will present the history and background of the passive income provisions of Section 936. It will also discuss the changes in policy which have combined to improve the effectiveness of this tax incentive. Chapter II will discuss the specific proposal which the Committee staff has made to modify existing legislation, and will show how it would affect financial markets in Puerto Rico. It will also evaluate the overall effects of the proposed measure, both on the Puerto Rican economy and on revenues for the U.S. Treasury. Finally, it will explore in greater depth the effects which the measure would have on one particular financial sector: the Federally chartered thrift institutions in Puerto Rico. It will conclude that the proposal would impose severe dislocations on financial markets in Puerto Rico, without making any significant contribution towards solving the revenue shortfall of the U.S. Treasury. A brief overview and summary will conclude the study.

CHAPTER I:

BACKGROUND ON THE TAX EXEMPTION FOR PASSIVE INCOME

(1) Historical Summary

The origins of the Federal tax exemption for passive income earned in Puerto Rico go back to the early postwar years, when Section 931 instead of Section 936 governed investment incentives for that island. Under this older system, a U.S. manufacturing subsidiary operating in Puerto Rico could shelter its profits from Federal taxation only by liquidating and bringing its accumulated profits back to the U.S. Usually, this was done after ten years, the normal period which the Puerto Rican government provided for exemption from island taxes at that time.

While accumulating profits for future tax - free return to the U.S., firms operating under the old Section 931 tax regime could -- and often did -- invest their funds anywhere in the world. The only restriction was that at least 50 percent of the firms' income had to come from the business which it carried out on the island. Thus, although the passive investment income brought no economic benefits to the Territories, it was still sheltered from Federal taxes.

The comprehensive tax reform of 1976 brought significant changes in the Federal tax incentives for investment in the U.S. Territories. Section 936, as part of this reform, was intended to tie Federal tax exemption more closely to measures which would promote the long - term economic development of Puerto Rico. This reform restricted tax exemption on financial investments to the income from assets in Puerto Rico which financed some type of economic development on the island. This measure led the companies operating in Puerto Rico to move their invested funds to the island on a massive scale, in order to preserve the Federal tax exemption on the interest they earned.

At the same time as it defined which sources of passive income could qualify for Federal tax exemption, the Congress also permitted 936 companies to remit profits back to the U.S. each year as they were earned, while still preserving their Federal tax exemption. Of course, certain other conditions had to be met to qualify for this tax exemption. But together, these two provisions significantly increased the incentives which the Federal government granted for private businesses to undertake investment in Puerto Rico.

When the TEFRA revsions of Section 936 were undertaken in 1982, Congress again tightened the passive income provisions of the orginal law. It reduced the maximum proportion of tax - free corporate income which could come from passive income, in five percent annual increments, from fifty to thirty five percent. Also, it further restricted where eligible investments could be located.

Shortly after Section 936 was passed in 1976, the Government of Puerto Rico also put into place a comprehensive reform in its own tax code, as well as its regulations. These changes were intended to improve on the benefits which the U.S. legislation would provide to the local economy. One significant change was to add a so - called "tollgate tax" on repatriation of 936 profits to the mainland. This was set at a basic rate of ten percent, but this rate could be lowered if the funds remained on the island for a substantial period of time. Besides providing some additional government revenue, this provision increased the differential in interest rates between the two areas as a result of the tax exemption on investments of accumulated profits by the 936 corporations.

The Puerto Rican government also freed from local taxes the income from a variety of other financial assets which contribute to Puerto Rico's economic development. These, which are listed in the Industrial Incentives Act of 1978, include housing mortgages and mortgage backed securities, Puerto Rican government bonds, business and construction loans, and rental fees from public buildings, as well as deposits in local banks which are used to finance similar development activities. The U.S. Treasury has generally accepted this same classification of eligible activities for purposes of determining which types of passive income are eligible for Federal tax exemption.

The island government also took other measures to increase the local economic effects of the Federal tax exemption on reinvested profits. Local government bonds, of course, were eligible for interest tax exemption from the beginning. In addition, banks receiving deposits from the 936 companies were required to deposit ten percent of these funds with the

Government Development Bank of Puerto Rico, the agency which manages the external borrowing of all Puerto Rican government agencies and public corporations.

To summarize, the basic rationale for making income from Puerto Rican investments tax exempt was to provide a low - cost source of funds to the island financial system. This, in turn, would reduce the costs of borrowed funds to finance local capital formation and to accelerate economic growth on the island.

(ii) Improvements in the Functioning of the 936 Financial Markets

As we have already showed, almost as soon as the Federal legislation was passed the Puerto Rican government took some preliminary steps to see that the benefits of tax exemption would be passed on to residents of the island. Still, neither Federal nor local officials appear to have given serious thought at the outset to the problems of fitting such a novel investment incentive into a conventional banking system which -- initially, at least -- was not well designed to use it fully.

But gradually, over the period since the system was introduced, a series of innovations have been making the system more competitive and better adapted to passing the lower cost of funds through to the ultimate borrowers. The Puerto Rico Treasury has made some of these changes; the Federal government has made others; and the private sector others still. The overall result is a financial system which functions very differently from the one in place in 1976 when Section 936 was first applied to the island.

Background

-Noncompetitive Interest Rates-

What were some of the problems which appeared in the early years of the 936 system? First, in the absence of tight local regulations there was a tendency for banks receiving low cost 936 deposits to arbitrage them, temporarily lending them out at higher interest rates in other financial markets off the island. This problem was solved by a series of progressively more stringent regulations by the Puerto Rico Treasury Department, requiring banks to move increasingly towards matching "eligible" loans (i.e. loans which contribute to the economic development of Puerto Rico and therefore qualify for making interest income exempt from Federal tax) with 936 deposits and providing detailed reports on each of these categories.

Even with this change, however, the system often failed to show the full interest rate differential compared to the Eurodollar market which would be expected from the tax - exempt status of the securities and bank deposits. These problems arose partly from the basically oligopolistic nature of the 936 transactions. In a nutshell, there were too few buyers and sellers for a smoothly functioning competitive market. Beyond this, the system tended to operate with an excess of eligible investments over available funds at any given time, and the cost of 936 funds was substantially below that of other sources of borrowed money. This tended to make the larger banks compete vigorously for deposits and kept the rates on deposits relatively high.

Background

How has the local Treasury Department overcome this problem in order to lower the cost of funds to the banks? In April, 1984 the agency adopted a new regulation which penalized banks for paying more than 64.9 percent of the Eurodollar rate for the deposits of the 936 companies. Treasury estimated that this was the relationship which should prevail between 936 certificates of deposit and outside interest rates if tax rate differentials were the only factor affecting the differential in interest rates. The penalty which banks would have to give up for paying higher rates of interest on their 936 deposits was to make more than $1.00 of loans in activities eligible for 936 tax exemption for each dollar of deposits accepted at the higher rates. And the higher the interest rate, the greater the amount of lending which would have to be undertaken per dollar deposited.

This new regulation has been very effective in lowering the rates which banks pay the 936 companies for their deposits. In doing so, it may also have increased the amount of funds which the corporations have repatriated to the mainland and kept the amount of deposits in line with the amount of lending activity which the banking system can support at those interest rates. The competition for 936 deposits has also greatly increased the degree of competition among Puerto Rican banks for construction and commercial loans.

-Unequal Access to Funds-

Another problem in the 936 financial markets has been the tendency of these funds to be concentrated in a reduced number of very large banks. The treasurers of the 936 companies prefer the security of large banks, and kept most of their funds at short term in a handful of the largest banks on the island: Chase, the Bank of America, and Citibank. Initially, at least, the locally owned banks received relatively few of these deposits and the thrift institutions none to speak of. Yet paradoxically, it is these smaller financial institutions which, through their specialized knowledge and relationships with local clients, are best suited to stimulating the type of local business development which the tax exemption on passive income was intended to bring about.

Several factors have been combining recently to change this situation. The first change was a liberalization of local government regulations which took effect in February, 1982. One provision of this regulation required a minimum proportion of bank deposits to be lent out in the form of mortgages for new housing. But the most important change in 1982 was to permit brokers for the first time to act as intermediaries in the 936 financial markets.

This change opened up a channel through which the smaller commercial banks and thrift institutions could gain access to the 936 deposits of large corporations -- although at very short term, and with somewhat higher interest rates than the larger commercial banks. The mechanism by which the brokers "spread out" the 936 funds through the financial system was the so - called "repo", or repurchase agreement. This involves the sale of a 936 security to a smaller institution, with an agreement to buy it back at a later time -- in effect, a short - term loan. The purchase and selling prices are arranged to provide a reasonable rate of interest to the "lender". The transaction carries little risk, as the security itself can serve as collateral.

Since brokers were permitted to enter actively into the 936 financial market these types of transactions have become a very popular way for the smaller financial institutions to gain additional funds at a relatively low cost. The U.S. Treasury's Fifth 936 Report shows that the amount of broker lending in activities eligible for 936 tax exemption increased from $ .9 billion to $2.0 billion between February, 1982 and April, 1984. As of March, 1985 the island's twelve thrift institutions alone held approximately $1.1 billion in repurchase agreements, many of which undoubtedly came from brokers.

Another recent initiative goes even farther towards redressing the unequal access of large and small banks to 936 funds. Recently the Federal Home Loan Bank of New York has agreed to guarantee the deposits of 936 companies in Puerto Rican Savings Banks. This program has already gone into effect, and about $125 million in 936 funds have been channelled into the local thrift industry, with deposit terms up to three years -- much longer than is generally available to other financial institutions which accept 936 deposits. The Federal Home Loan Bank has also guaranteed $635.8 million in term and capital notes issued since 1982 by its member banks and purchased by 936 companies. This change should improve the competitiveness of the thrift institutions by putting them on an equal footing with the commercial banks in their access to 936 funds.

-New Uses for 936 Funds-

The Hernandez - Colon administration in Puerto Rico, which came to power in January, 1985, has placed considerable emphasis on finding socially productive uses for 936 funds which market - oriented private investors would normally not seek out. One example of this type of initiative is a new Mortgage Investment Trust, which is designed to channel 936 funds into low - income housing.

One reason why 936 funds have not been used extensively to finance housing in the past is that company treasurers, proccupied with the security of their principal, have invested their funds largely in short - term certificates of deposit in the larger banks. Generally speaking, however, banks are reluctant to make very long term loans such as mortgages which are backed only by short - term deposits.

The Mortgage Trust would solve this problem by providing a special fund, guaranteed by the Government Development Bank of Puerto Rico, to accept longer term deposits from the 936 companies and to relend these funds for special programs to finance low cost housing construction. In August, 1985 the Mortgage Trust sold $220 million in medium term notes to 936 companies. The proceeds of the sale are being used in part to finance mortgages on 3,000 to 5,000 housing units. Part of the funds are also being used to finance the purchase of a zero coupon bond which will eventually repay the principal of the note issue. The Government Development Bank is also planning to use 936 funds to help finance the establishment of a new "development bank", intended to foster the growth of locally - owned and operated businesses. But the details of this plan had not yet been made public when this was written.

The Government Development Bank of Puerto Rico has also developed a special program to make loans on concessionary terms to finance joint production projects involving Puerto Rico and other Caribbean islands. These projects generally involve production sharing arrangements, in which the labor - intensive components of a production process are carried out in low - wage countries such as Haiti or the Dominican Republic, while the skill - and capital intensive parts are performed in Puerto Rico.

The Bank will make these concessionary loans using the 936 funds which banks receiving these deposits are required to place in that institution. These deposits totaled $961.1 million in May, 1985. Of course, only the Puerto Rican component of a "joint production" or "twin plant" arrangement could be financed in this way. However, the program will frequently provide capital for these types of ventures on more favorable terms than would be available in other Caribbean countries, or through conventional bank lending on the mainland. This program is only now beginning, and only a couple of loans have been made thus far. However, the

Government Development Bank expects it to create a substantial number of jobs in Puerto Rico in coming years.

Agriculture is another area in which 936 funds were relatively little used until recently. Puerto Rican agriculture is dominated by small, family operations which may not be able to qualify for commercial loans under the conventional guidelines used by most banks. Evaluating loan applications from island farmers requires, in addition, a degreee of specialized knowledge of farm management which most bank lending officers do not have. For these reasons, among others, private markets had not functioned well in passing on the cost savings from 936 funds to the agricultural sector.

Recently, however, an innovative program in the private sector has also begun channelling 936 funds into this area. The Farm Credit Bank of Baltimore has sold $150 million in notes to the 936 companies for purposes of agricultural lending. These loans will be offered roughly 1.5 percent below the interest rates which farmers have previously had to pay for credit.

-Summary-

When 936 was first put into place in the late 1970's, financial markets on the island were not set up to fully pass through the benefits of these low - cost funds to island businessmen and consumers. However, this situation has been changing rapidly, especially during the past three years. A number of institutional changes have greatly improved the functioning of this market. These include better regulation by the Puerto Rico Treasury to hold down the cost of 936 funds to the banks, broker activity and FHLB guarantees to make funds more readily available to smaller, local banks and to thrift institutions, and innovative private and public programs to finance activities in areas not previously reached by the 936 market. Increasingly, then, the 936 market has come to play an important role in Puerto Rico's economic development.

CHAPTER II:

THE CONGRESSIONAL PROPOSAL AND ITS POTENTIAL EFFECTS

The most recent proposal for reform of Section 936, formulated by the Joint Tax Committee of Congress, would place a tax of fifty percent on passive income earned by 936 corporations. In this section we will first examine what effects this change would have, in combination with other changes also proposed for the comprehensive tax reform bill. Later, we will survey its potential effects on financial innovations in the 936 market, which we discussed in Chapter I.

(i) Generalized Effects

By taxing part of the return from 936 deposits, the proposed legislation would reduce the effectiveness of Section 936 in stimulating long - term development in Puerto Rico. As we stated in the previous chapter, the tax exemption on interest from local financial assets created a differential between the interest rates on funds available to the local banking system and those paid on outside funds. After certain reforms carried out by the island's Treasury Department, the rate paid by island banks on certificates of deposit has fluctuated in the area of 70 to 75 percent of the Eurodollar rate on equivalent assets. In this way, this provision has permitted companies operating on the island to inject low - cost funds into the island financial system, increasing the corporate benefits to the local economy.

Proposal and Effects

The new proposal would effectively remove most of this interest rate differential -- and with it, the economic benefits provided by the tax exemption on passive income. Experts on the 936 financial market calculate that under this proposal the nominal interest rate on 936 deposits would rise from the current 70 percent to approximately 90 percent of the Eurodollar rate. And even at this higher level, it is questionable whether the after tax return in Puerto Rico would be sufficiently above what is available elsewhere to justify the subjectively perceived risk in leaving the funds on deposit in Puerto Rican banks.

Why should the differential decrease by more that half if the tax is fifty percent? The answer is that the tax reform proposal would not only tax Puerto Rican passive income, but would also reduce corporate tax rates, thereby cutting into the gap between taxable and tax - free rates of interest.

Specifically, based on an 8 percent Eurodollar rate the current nominal interest rate paid by Puerto Rican banks on short - term 936 deposits would be in the area of 5.6 percent, or 70 percent of Eurodollar. After the change, the rate would rise to at least 7.6 percent, or 90 percent of Eurodollar. However, when these funds were repatriated the company would have to pay 17.5 percent in Federal taxes, reducing after - tax yield by 1.33 percent (based on an assumed mainland corporate tax rate of 35 percent). In addition, the company would have to pay a ten percent Puerto Rico tollgate tax, reducing after - tax yield by another .76 percent. The net yield, at 5.51 percent, would barely exceed what the company could earn by repatriating the funds, paying the full corporate tax on the earnings, and investing them in some asset similar to Eurodollar deposits.

Is it plausible to expect that companies would maintain large deposits in Puerto Rico if the returns off the island were virtually equivalent? In answering this question one must remember that Corporate Treasurers are generally very reluctant to enter into transactions which involve the slightest risk of loss. And repeated attempts by Congress and the Treasury to amend Section 936 have planted substantial doubts in the minds of Puerto Ricans concerning the future solidity of U.S. support for the island. Reminders of these doubts appear almost daily in the local Spanish language press, and cannot help but color the thinking of local 936 executives, however tenuous the evidence supporting these speculations might be. In the past, we have seen repeated examples of situations in which U.S. investment follows the flag. And financial investments are the most volatile and sensitive to shifts in the political winds.

Both numerical calculations and psychological considerations therefore lead to the same conclusion: a massive withdrawal of 936 funds from the Puerto Rican financial system is likely to occur if Congress passes the proposed 50 percent tax on passive income. Since the vast majority of 936 deposits have less than three months maturity, this shift of funds could occur quite rapidly. And given the psychological climate currently prevailing in Puerto Rico, it is certainly possible that additional capital flight from the island would follow.

Why did these same results not follow when Congress last changed tax provisions on passive income in 1982? The 1982 change was fundamentally different in that it did not involve a tax on all interest earned in Puerto Rico, but rather a reduction in the maximum proportion of total tax - free Puerto Rican income which could come from passive sources. For this reason it did not affect the spread between local and outside interest rates (except temporarily, when deposits were removed from the banking system) and it maintained incentives for 936 companies to keep their deposits on the island. Thus, the fact that a massive capital flight did not occur in 1982 is no indication that such a result would not occur with the passage of this new proposal.

(ii) Effects on Specific Sectors and Programs

-Gains to the Federal Treasury-

Would the gains to the U.S. Treasury be sufficient to justify this wholesale dislocation? Clearly Treasury would collect relatively little on the passive income tax itself, since the deposit base on which this tax is assessed would be drastically reduced. But if the funds were repatriated to the U.S., they might be reinvested in other securities on which some tax would be collected in the future. In this sense, the measure would produce revenue for the Federal government. But this reasoning assumes that the funds displaced from Puerto Rico would be repatriated to the U.S. rather than being moved to some other location. Most 936 deposits are held by large, multinational corporations with extensive worldwide operations. A true estimate of the revenue effects would therefore have to be based on careful study of returns to corporate funds in different areas. It is not clear whether these factors were considered in estimating the revenues which Congress hopes to gain from the measure.

-Effects on the Island Banking System-

There is no question but that this change would cause massive disruption in the Puerto Rican financial system, since roughly forty percent of the island's bank deposits are made up of 936 funds. And clearly a loss of deposits on the scale of a major loss of 936 deposits would set off a war among local banks for other types of deposits. The losers in this war would have to turn to expensive, short - term money to replace lost deposits, or begin to sell off some of their assets to raise cash. The result would be a sharp rise in the cost of funds to the local banking system and a considerable increase in the interest rates charged to local borrowers.

It is perfectly possible that some of the weaker banks or thrift institutions could become insolvent in this situation. Since both commercial banks and thrift institutions in Puerto Rico are Federally insured, this change could also affect U.S. deposit insurers.

Proposal and Effects

-Effects on Puerto Rican Government Programs-

A sharp reduction in 936 funds invested on the island would raise the debt service costs of the government, since the value of Puerto Rican bonds would be reduced and the cost of raising funds with them would increase. In addition, the change would put in jeopardy some new programs guaranteed by the government, such as the Mortgage Trust described in the first chapter. This, combined with the effect on the thrift institutions described below, would also affect adversely the housing market on the island. It is probable that the Caribbean "twin plant" lending program would have to be cut back; some other programs such as the new development bank might have to be abandoned completely.

The change in the tax treatment of interest income could also affect other programs involving the past sale of 936 notes, such as the FHLB guaranteed notes of the Puerto Rican thrift institutions and the private sector note issue for agricultural finance. Since 1982, island thrift institutions have issued a total of $635.8 million in term and capital notes guaranteed by the Federal Home Loan Bank and sold to the 936 companies. And the farm credit program described earlier involved an additional $150 million. Here, much would depend on the precise wording used in the legislation.

-Effects on Island Thrift Institutions-

Puerto Rico's financial system includes a dozen Federally regulated thrift institutions, with $4.8 billion in combined assets and $2.9 billion in loans and mortgage - backed securities. These financial institutions passed through the same period of difficulties as mainland thrifts during the late 1970's and early 1980's. These problems had the same basic causes in both cases: a rapid rise in the cost of borrowed funds, combined with fixed returns on money lent out. This cost "squeeze" was basically due to the large amount of mortgage finance undertaken by these institutions.

Unlike the mainland experience, however, Puerto Rico experienced no failures among its thrift institutions during this difficult period. This positive development was due at least in part to the availability of low - cost 936 funds, although advances from the Federal Home Loan Bank were also an important factor in the survival of some Puerto Rican thrifts. Although the island thrift industry has been restructuring its operations rapidly since the last period of high interest rates, it could still be vulnerable to rapid increases in the cost of its funds, and may remain so for several more years.

At the same time, the Puerto Rican thrift institutions can now play a more positive role than was possible before in spreading the benefits of 936 funds throughout the Puerto Rican economy. Puerto Rican thrift institutions were affected in the same way as mainland thrifts by the recent deregulation moves by Congress. They are taking full advantage of their ability to engage in commercial and personal lending activities. But unlike the large, mainland banks which have traditionally been the main recipients of 936 funds, the thrift institutions are best positioned in the local credit market to aid small, locally owned businesses and professional people. They are also maintaining their traditional role as mortgage lenders, though to a lesser degree than in the past.

Now that the Federal Home Loan Bank is guaranteeing 936 deposits in these institutions, they can compete for commercial loans on an equal footing with the larger institutions. This change should greatly increase the competitiveness of credit markets in Puerto Rico and expand the range of benefits which the tax exemption on interest income can provide to the local economy. Because of the tight regulations imposed by the Puerto Rican government, these newly acquired 936 deposits must be used to finance activities which benefit the Puerto Rican economy.

SUMMARY AND CONCLUSIONS

We have seen throughout this study that the 936 financial market has been going through a remarkable evolution during the last few years. New local government regulations have locked in a substantially lower cost of funds to the local banking system. New intitiaves by the Federal Home Loan Bank, combined with the deregulation of the thrift institutions by Congress, have brought these banks into the 936 financial system on a substantial scale for the first time. And the private sector has begun extending 936-based credit to local agriculture on a substantial scale.

In addition to these changes, the new government of Rafael Hernandez Colon is pushing forward a series of innovative programs which would extend 936 financing to low - income housing and to joint production projects with other Caribbean countries. This financing would also be used as the basis for establishing a new development bank to finance locally based commercial and industrial projects.

Taken all together, the extent of these changes in the 936 fiancial market is substantial. These changes have a clear promise of increasing the benefits which Section 936 provides to Puerto Rico. Many of them are also quite recent, and have not been covered the the periodic Treasury reports on the functioning of Section 936.

Summary

Given all this, it would seem reasonable for Congress to provide additional time to evaluate these numerous changes and experiments before reaching a final decision concerning this tax provision. This is especially true when one considers that the gains to the Federal budget from reducing the tax exemption on passive income are small and uncertain. Section 936 has always had goals which are different and longer - term in nature than most special tax provisions which Congress has provided for particular industries or sectors. Its goal is the socioeconimc development of an entire island which only thirty years ago was completely underdeveloped.

The modifications to Section 936 which are now being considered would do more damage than simply disrupting financial markets and creating circumstances which invite reorganization or outright failure among the weaker financial institutions. They would also undo the efforts of many individuals and institutions, undertaken over many years, to build a financial system which will provide widespread benefits throughout the Puerto Rican economy. And most of all, they would provide one more reason for Puerto Ricans and their Caribbean neighbors to question the long - term commitment of the United States toward protecting and developing the island.

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Statement of Position of the
National Association of State Utility Consumer Advocates

Before the
Senate Finance Committee

Statement of Position on Aspects of the President's
Tax Proposals to Congress Affecting Utility Ratepayers

October 3, 1985

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INTRODUCTION

The National Association of State Utility Consumer Advocates (NASUCA) is composed of officials in 34 states and the District of Columbia who are directed by law to represent the interest of consumers of regulated public utility services before state utility commissions.

As a result of their direct involvement in literally billions of dollars worth of utility rate cases throughout the United States, NASUCA members have had an opportunity to review financial data of utilities and to become informed about various tax matters affecting utility ratepayers. NASUCA welcomes this opportunity to express its views to this Committee. The President's proposed Federal income tax reform would have a substantial effect on the Federal tax liability of public utilities and, therefore, ultimately on the ratepayers who bear the costs of the federal income taxes in their rates.

We do not have the time to address all facets of the President's proposal which affect the utilities' tax liability; nor, is it absolutely necessary. Therefore, we are not addressing issues such as the reduction of the corporate tax rate and the repeal of the investment tax credits. Instead, we would like to bring attention to five aspects of the President's tax proposal which would significantly affect the ratepayers whom we represent.

Three of these considerations are a result of language in the proposal: Excess Depreciation Accruals, Capital Cost Recovery System, and Partial Deductibility of Dividends. Two of the considerations, Deductions for Nuclear Power Plant Decommissioning Costs and Elimination of Mandatory Tax Normalization, are currently not parts of the tax reform proposal, and we recommend that they be.

Excess Depreciation Accruals

If the maximum corporate tax rate is reduced from 46% to 33%, a significant excess accrual will result in the utilities' deferred tax accounts. This results because the deferred taxes associated with accelerated depreciation were established at the 46% rate and the reduction of these balances would have occurred at the same rate. The deferred taxes result from accelerated depreciation claimed for tax purposes being higher than the straight-line depreciation claimed for book purposes. Conversely, when the straight-line becomes higher than the accelerated, the deferred taxes are reduced.

However, the deferred balances would now be reduced at the 33% rate, with the result being that the utilities would not have to flow back these deferred taxes to the consumers in the same manner they were collected. In other words, the utilities would be able to keep their deferred taxes for a longer period of time and absent some form of special treatment could retain the accrued deferred taxes indefinitely.

The President's proposal recognizes this "windfall benefit" and as a result provides that 40% of the excess depreciation taken between January 1, 1980, and July 1, 1986, should be included in income over a three-year period. (It is the deferred taxes on the excess depreciation which will actually be amortized to income; not the excess depreciation.)

We support this aspect of the President's proposal as the minimum treatment which should be afforded the excess deferred tax accruals. The ratepayers have borne the cost of the tax deferrals in their rates at the 46% rate. If the rate is lowered to 33%, then the portion of the deferrals which relate to the 13% rate difference should be immediately provided to the ratepayers. The remaining deferred tax accruals will be included in income based upon the 33% rate in the same manner they would have been at the 46% rate. The utilities should not be permitted to benefit by holding on to these deferrals which have been paid for by the ratepayers.

Further, we note that the President's proposal does not address the remaining 60% of the excess depreciation taken between January 1, 1980, and July 1, 1986. Neither does it address the excess depreciation taken prior to 1980. It is important to remember that accelerated depreciation has been permitted since 1954 and as a result significant excess depreciation which results in significant deferred tax accruals could be associated with the pre-1980 excess depreciation.

We urge that the proposal be modified to allow the excess tax deferrals which originate because of the reduction in the maximum corporate tax rate to be returned to the ratepayers who have borne the costs in their rates over the proposed three-year period.

Capital Cost Recovery System

We are neither supporting nor challenging the proposal to abolish the accelerated cost recovery (ACRS) and replacing it with the capital cost recovery system (CCRS).

Our major concern in this regard is that Congress allow the state regulatory commission to determine the appropriate ratemaking treatment which should be afforded the differences between taxes paid and taxes expensed which results from the use of CCRS depreciation for tax purposes and straight-line depreciation for book purposes. We believe that the state regulatory commissions and the state consumer advocates who represent the ratepayers are better equipped to determine the appropriate ratemaking treatment for the individual states than Congress can on a generic basis. After all, it is these entities who are familiar with the particular state laws and the particular needs of the ratepayers who foot the ultimate cost of the ratemaking treatment chosen.

Further, it is important for Congress to remember that the dollars generated for the Treasury remain the same no matter what ratemaking treatment is allowed. Thus, there is no requirement to mandate normalization treatment for the tax difference which results from the use of the CCRS depreciation rates.

Finally, we believe the inflation-adjusted cost recovery portion (i.e., the amount recovered over original cost) is not compatible with deferred income tax accounting, because the recovery of it could result in permanent tax-to-book differences instead of the timing differences which result when only the original cost is being recovered. A recovery of permanent tax differences would be in violation of generally accepted accounting principles.

Partial Deductibility of Dividends

This proposal will allow corporations to deduct up to 10% of dividends paid to their shareholders. The proposal does not, however, state what the appropriate ratemaking treatment should be.

We urge the Congress to state that the appropriate ratemaking treatment is to flow through the tax savings which are generated to the consumers. This treatment would reflect generally accepted accounting principles. In lieu of this, we urge Congress not to dictate any ratemaking treatment and to allow the state regulatory commissions to establish the appropriate ratemaking treatment.

Also, we urge the Congress to consider providing for tax deferrals for dividends reinvested in qualified dividend reinvestment plans. The ERTA of 1981 contained a provision in this regard but it is scheduled to expire at the end of 1985.

We note that dividend reinvestment plans have proved very successful to raising substantial sums of capital, and the continued tax deferrals for the dividends reinvested will allow this to continue.

Deductions for Nuclear Power Plant Decommissioning Costs

As you are aware, a large number of major electric rate increases have been filed across the United States due to the completion of major nuclear generating facilities. A part of the increase which the consumers must bear relates to the decommissioning costs which will be collected during the life of the plant so that it can be disposed of properly when the plant's useful life is over. In other words, nuclear plants have to be dismantled, mothballed or entombed at the end of their useful lifes; this is known as decommissioning.

Currently, however, when the utilities collect the decommissioning funds from the ratepayers as revenues, they are forced to pay taxes on this amount. Of course, these taxes are then passed on to the ratepayers. This procedure causes the ratepayers to pay almost double (based upon a 46% rate) for the amounts they are paying to decommission the plants. This is sometimes referred to as the 2 for 1 effect.

We recommend giving tax-free treatment to the decommissioned funds so that ratepayers will not be forced to pay for the costs of the decommissioning as well as the taxes which relate to the costs when they are collected by the utilities. In other words, it is our proposal that decommissioning costs be excluded from taxable income, as long as these amounts are restricted to decommissioning use and are maintained independently of utility general funds in such a manner that will insure that the amounts collected and their associated earnings will be available to cover the costs of decommissioning. NASUCA is not recommending a particular type of decommissioning or method of funding decommissioning.

Elimination of Mandatory Tax Normalization

NASUCA believes State commissions and the Federal Energy Regulatory Commission should have the discretion to determine whether ratepayers will pay through their electric rates only the actual taxes currently paid by the utilities or whether they will pay currently what may be tomorrow's taxes for these utilities. Proponents of a flow-through approach favor building in only actual taxes into ratemaking, which is consistent with the principle of using known data in original cost jurisdictions. Proponents of normalization favor building in other taxes that may or may not be paid tomorrow. Often referred to as deferred taxes, this term is a misnomer. From an accounting standpoint a deferred item is one incurred currently but related to a future year. Since there is uncertainty whether utilities will ever pay these so-called "deferred" taxes, the term "phantom" tax has become popularly applied. At best the term "deferred" taxes merely refers to possible future taxes. Even if the taxes are paid; however, normalization charges the wrong ratepayer for the tax, as taxes are typically charged. See, e.g., Liberman, Normalized Taxes in Utility Rates: Giving Credits When None are Due, 30 S.C. L. Rev. 703, 757 (1979). Professor Liberman also sets forth several legal infirmities of normalization. Id., at 761-779.

With stable, moderate growth utilities may well continue to replace and build new generating plants. However, utilities have not experienced the dramatic 10% growth of the 1960's throughout the 70's nor do they expect this level of growth for the remainder of the century. Privately owned utilities operating in South Carolina, for example, currently project approximately 2.0-3.0% annual increases in peakload and approximately 3.0% annual increases in energy sales over a 15-20 year time horizon. These projections are reflective of the industry. Therefore, future accelerated depreciation on new equipment could be depleted by utilities through their efforts to maintain the levels of their accumulated deferred tax reserves and might not be available "for maintaining benefits generated during the later part of the building period." Liberman, *supra*, at 733. The present reserve capacity status of the industry supports the possibility that this crossover point is in the foreseeable future. *See* Testimony of Andrew Varley, Chairman of the Iowa State Commission and Chairman of the NARUC Committee on Electricity, before the Subcommittee on Energy Conservation and Power, House Committee on Energy and Commerce on February 7, 1984. Commissioner Varley noted that the electric utility industry has reserve margins in the range of 35-40 percent with 1983 electricity generation statistics running only slightly ahead of 1981 levels. A 20% margin for generating capacity is generally considered to be adequate. Liberman, *supra*, at 703, n.4.

The Committee should note that prior to normalization, the "actual tax" notion had been generally accepted. *See* *Galveston Electric Co. v. City of Galveston*, 258 U.S. 388, 399-400 (1922). NASUCA contends regulated utilities do not need a device, such as normalization, that is an aberration from usual ratemaking practices, since regulators will still have their basic duty to provide a fair return to the utilities by setting "just and reasonable" rates. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

TESTIMONY OF
JAMES W. DAMON
BEFORE THE U.S. SENATE FINANCE COMMITTEE
OCTOBER 3, 1985

Mr. Chairman and Members of the Subcommittee, I am James W. Damon, President of the Oregon Telephone Corporation, Mount Vernon, Oregon, submitting this testimony on behalf of the United States Telephone Association (USTA).

I am here today to speak not only on behalf of my company, but also on behalf of the other 1400 small companies that have legitimate concerns about the negative effects the new tax proposals will have on capital formation.

My remarks will be brief and confined to four major issues, all of which deal with capital formation. Before addressing the tax proposal however, I believe it would be worthwhile to spend some time on small company background.

The non-Bell companies serve approximately 60% of the geographical United States. While local exchange service to any area is a capital intensive business, ours is more capital intensive than those companies that serve metropolitan America. The capital cost to serve each new customer in a rural area can run from $2,500 to $10,000 or more.

We are in the midst of a regulatory, technological and competitive revolution. We did not seek out these changes, they were thrust upon us. Rules that we based long term investment decisions upon were altered abruptly in midstream. Our competitors may pick and choose the most profitable customers while we are required to serve anyone who requests our service.

Faced with the information age as well as competition from satellite, cellular and other by-pass technology, we must invest heavily in the most modern plant available while seeing old plant stranded and at risk because historically our depreciation lives have always been and continue to be extended to keep rates to our customers low.

At a time when we need more capital than ever before, we find ourselves unable to recover the capital invested in outdated and obsolete plant. When we look to the capital markets, we see major U.S. corporations borrowing for massive plant replacement; the federal government borrowing to finance it's deficits and still other major U.S. corporations borrowing to finance their latest multi-billion dollar acquisition. Obviously, the result will be a high cost of money for the smaller companies, companies which now must approach lenders with no protected revenue stream or service area and billion dollar competitors.

To add further fuel to the fire, there have been recent attempts to terminate the REA program - a program which made it possible for rural companies to secure financing to provide telephone service to rural America.

The changes contained in the Administration's latest tax proposal will also impact our ability to form and attract capital - capital which is cost free to our telephone customers.

The four major areas that I will address are:

1. The Investment Tax Credit
2. Depreciation Lives
3. Normalization
4. The Recapture Tax

The President's Tax Proposal would eliminate the Investment Tax Credit. The incentive to invest in manufactured capital goods would be removed at a time when our economy is rapidly losing its manufacturing base to foreign countries. The industries that use and supply capital goods would be adversely affected while the service industry would be left unaffected. Closer to home, ITC provides telephone companies with a source of capital which under the regulatory process is cost free to the ratepayers of this country. The removal of the investment tax credit would result in higher rates for telephone service when local telephone rates are already projected to triple. We would ask that the ITC be continued or in the worst case, phased out over a period of time.

The second area of concern deals with Depreciation Lives. Earlier, I mentioned the stranded plant that exists today because the time required by the several regulatory commissions to recover the investment in an asset was too long.

Unreasonably long depreciation lives were tolerable when we operated in an environment where we controlled the introduction of new technology and the obsolescence and retirement of old technology. Now, however, the marketplace - competitors, users and the rapid changes in technology - dictates the life of an asset and accordingly the time required to recover the capital invested in these assets. The lives of our facilities must be decreased. More specifically, our equipment must be treated from a depreciation life standpoint the same as equipment of a similar nature used by other industries.

A case in point is the computers - digital central offices - that we use to switch communications traffic. Our computers perform the same function that computers in manufacturing, data processing and service industries perform. Parity in computer lives must exist if the tax laws are to be applied fairly and realistically.

In our industry, we have coined the catch phrase - "a minute is a minute is a minute." It simply means that our minute of use charge for the use of our systems should be the same if uses are the same.

In all fairness, the same approach should be used in assigning the lives for our central office computers. "A computer is a computer is a computer." We would ask that depreciation lives be shortened and that our computerized digital central offices be assigned the same lives as computers used in other industries.

Normalization is a term esoteric to the utility industry. Simply put, normalization allows utilities to use tax savings that result from the use of accelerated depreciation over straight line depreciation as cost free capital; that is, cost free to our customers. The current tax code insures that congressional intent is protected by establishing a penalty that is triggered when regulatory commissions attempt to deprive the utility of the use of this capital. The penalty denies accelerated depreciation in those instances where regulatory commissions attempt to frustrate Congressional intent by depriving companies of this benefit.

While the new tax proposal allows for normalization, it is not clear whether the penalty would be continued. It is our position that unless the penalty is continued, the intent of Congress will be thwarted by state regulatory bodies. This was proven out in California where such an attempt was made.

Finally, we oppose the Windfall Recapture Tax because it is retroactive in nature. It would work to tax investments that were made during the years 1981 through June of 1986. Those investments were made under the law that existed at that time. To change its treatment going forward is legal, but to change retroactively is not only unlawful, it is unfair. For these reasons, we oppose the recapture tax.

In summary, we would ask that you:

1. Preserve the investment tax credit.
2. Implement realistic depreciation lives - recognizing that a "computer is a computer is a computer."
3. Continue the penalty that applies in the current code when flow through is used in place of normalization.
4. Oppose the recapture tax as being retroactive and unfair in nature.

Thank you for the opportunity to state and explain our concerns. We know that there will be difficult choices to make in the next few months. We only ask that you weigh the impact of your decisions on the small telephone companies that serve rural America. I will try to answer any questions you may have.

TESTIMONY TO BE OFFERED BY MIRIAM J. RAMIREZ DE FERRER MD, CHAIRPERSON OF PUERTO RICANS IN CIVIC ACTION, TO THE SENATE FINANCE COMMITTEE REGARDING SECTION 936 DURING THE OCT. 3, 1985 HEARINGS:

MR. CHAIRMAN, HONORABLE MEMBERS OF THE FINANCE COMMITTEE, AND DISTINGUISHED STAFF MEMBERS:

My name is Miriam J. Ramírez de Ferrer. I am a Medical Doctor, practicing in Puerto Rico. I am also a mother of five, a wife, and the Founder and Chairman of a Non-partisan Citizen's Movement called Puerto Ricans in Civic Action. This group has organized the first grassroots citizens' Petition drive ever held in Puerto Rico and it will reveal the strength of the statehood movement on the island.

Our Organization collects individually signed petitions to request Congress to admit Puerto Rico as a State of the Union. On June 18, 1985, we had the honor of delivering 100,00 signed petitions to Congress and to the Vice-President of the United States, the Honorable George Bush.

We are making considerable progress in gathering more signatures to prove to the President of the United States, to Congress and to the world, that the majority of the people of Puerto Rico want statehood. The US citizens in Puerto Rico are confident that the United States Congress, recognizing the principles of equal rights that are noted in our Constitution, will keep the promise they stated in a joint resolution passed by Congress in 1979, to respect and support the freely expressed will of the people of Puerto Rico.

We are responsible American citizens and we share your concern about the size of our National deficit. We feel it is our duty to participate with our fellow citizens in making sacrifices proportionate to our means, as we have done in the past, when we have joined hands to defend our Nation.

We know that you will have the best interest of all American citizens in mind in the final decision you make, but it is imperative that you realize that our present political situation is not permanent, and that we, the people of Puerto Rico, have launched our drive for Statehood. We also understand, and history has shown this, that statehood will bring the economic stability we need to develop our island to face the future with confidence and dignity, the same as the rest of our fellow citizens throughout the United States.

Our alternative solution to Section 936 is to undertake jointly with you the process of making Puerto Rico a full participating State of the Union. We suggest the passage of an enabling act that will include a gradual phase out of Section 936, or any other such concessions given to us in its place, as the other benefits of Puerto Rican Statehood would manifest itself in our economy.

Section 936 was especially created to promote employment and economic progress in the territories. It demonstrates the good will and concern that Congress has always shown towards the people of Puerto Rico to insure our political and economic stability. Now we are ready to enter that last stage, but in order to do so, we must redefine our status. The time has come for the people of Puerto Rico and the United States Congress to share new responsabilities. We are eager to accept our new responsabilities.

The phase out of Section 936 could be linked to the ratio of Puerto Rico's per capita income level relative to that of the Nation as a whole, or to some other comparable formula. We also feel it is feasible to establish the wage-credit plan in the short run, perhaps in combination with 936, and then evaluate the results of these concessions over a given period of time.

However, the benefits to the Puerto Rican economy following statehood will be attributable to increased participation in the Federal system. These benefits will include:

- Increased participation in public works programs on a par with other states;
- Full participation of the nation's agricultural programs that would stimulate our farming sectors;
- Fuller development of our tourism industry as the rest of the nation accepts Puerto Rico in its fold as happened in Hawaii;
- Increased financial investment because of the stable political situation found in full fledged states;
- Intellectual efforts would be focused upon productive areas instead of sterile debates about status;
- Increased participation in defense and government sponsored competitive contracts;

We will not continue mentioning these benefits since all of you members of this Senate Committee are well familiar with them. We respectfully, but firmly, request that you adopt a courageous attitude to help us solve this urgent problem and to help us open the way to a brighter future for all the people of our United States.

Miriam J. Ramírez de Ferrer
Chairperson
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PUERTO RICO BANKERS ASSOCIATION
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SUITE 820
HATO REY, PUERTO RICO 00918
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STATEMENT OF
HECTOR LEDESMA
ON BEHALF OF
THE PUERTO RICO BANKERS ASSOCIATION AND THE PRIVATE SECTOR STEERING COMMITTEE TO PRESERVE SECTION 936
BEFORE THE
SENATE FINANCE COMMITTEE
October 3, 1985

My name is Hector Ledesma. I am President of the Banco Popular of Puerto Rico, current President of the Puerto Rico Bankers Association, and Chairman of the Private Sector Steering Committee to Preserve Section 936. The Steering Committee is a broad-based group of over 30 local community organizations and trade associations in Puerto Rico, among them labor unions, wholesalers, retailers, financial institutions, manufacturers, builders, and service industries including accounting, engineering, and architectural firms, tourism, and realtors. There are no Section 936 companies in this group. We formed the Steering Committee to represent the interests of the private sector in Puerto Rico since we are firmly convinced that we would be as directly affected as Section 936 companies by any proposals to replace or limit Section 936.

The President's Tax Proposal to the Congress for Fairness, Growth and Simplicity dated May 29, 1985, as well as the Summary of Tax Reform Options for Consideration by Committee On Ways and Means prepared by the Staff of the Joint Committee on Taxation dated September 26, 1985, propose inter alia either the outright repeal of Section 936 or the full taxation of one half of the qualified possession source investment income ("passive income") earned by a possession corporation. Any one of these actions, or of the other proposed changes in Section 936 set forth in said Summary, would severely disrupt the island's financial system. To me, what to do about Section 936 is the most important decision Congress will make about Puerto Rico for a long time. I urge you to keep in mind the profound, direct impact the Administration's proposal will have on the 3.2 million U.S. citizens in Puerto Rico.

I would like to comment on several aspects of both the President's proposal and the Joint Committee staff options. First, I wish to stress the fact that Section 936 has become the principal economic underpinning of the Puerto Rican economy, both in terms of employment generated and in terms of the strength and liquidity it has provided to our financial system. The proposals now under consideration by Congress would produce severe dislocations upon the island's financial system. Second, I would like to emphasize to the Committee what Governor Hernandez Colon has said regarding the central role that Puerto Rico plays in the Caribbean Region, and the importance of the Governor's program to use Section 936 funds in promoting the objectives of the Caribbean Basin Initiative.

Section 936 and the Financial System

Adverse Effects of the Proposals on the Island's Financial System

Congress enacted Section 936 in 1976, providing a full credit against U.S. tax on income from business activities and from qualified investments in Puerto Rico. The 1976 law also made taxable investment earnings of those corporations derived from sources outside Puerto Rico. As a result of these changes, possessions corporations began to return to Puerto Rico funds held overseas (primarily in the Eurodollar market). The influx of these funds alleviated the critical lack of resources being experienced by our financial system at that time and provided the impetus for economic growth.

These so-called Section 936 funds now account for $6.8 billion of commercial bank deposits, out of total commercial bank deposits of $15.4 billion and for $1.1 billion of thrift institution deposits, out of total thrift institution deposits of $2.75 billion in Puerto Rico. These deposits currently represent approximately 44 percent of total deposits in commercial banks and approximately 40% of the average balance of deposits of thrift institutions on the island. These funds are vital to the banks' ability to finance new economic activity in Puerto Rico.

The Section 936 deposits are characterized by their short term nature. Approximately 70% of all such deposits bear maturities of 90 days or less; only 10% have maturities of one year or longer. The reason for the short term nature of these deposits is that corporate treasurers are very much risk adverse. Uncertainty over interest rates, corporate cash needs and future changes to Section 936 compel these corporations to keep these funds in relatively liquid form so that they may be repatriated to the mainland or to anywhere else in the world with a minimum of delay.

The proposed changes in Section 936 could prompt the massive withdrawal of over 40% of the island's deposit base within a very short time thereby creating serious liquidity problems for the island's financial sector. Why would the taxation of one half of the passive income prompt such a withdrawal of deposits? The tax exemption on passive income established a differential between the rates earned on Section 936 deposits or investments in Puerto Rico and the rates earned on comparable taxable investments in the Eurodollar market. The combined effect of taxing one half of the passive income and reducing the over-all federal corporate tax rates to 35% will virtually eliminate the differential. With the elimination of the differential, there will be no inducement for corporate treasurers to keep their earnings on deposit in

Puerto Rico; instead, they will probably prefer to seek "safer" investments on the mainland which will yield a comparable after tax return.

What effects would the rapid withdrawal of most or all of these funds have on the island's financial system?

The removal of approximately 40% of the deposits or Puerto Rico's banking system would produce immediate and potentially catastrophic effects. In order to compensate the loss of deposits and relieve the strain on their liquidity, banks and thrift institutions would begin a costly competition to attract non-Section 936 funds. This intense competition would require financial institutions to offer much higher interest rates on their time deposits with a resulting increase in the cost of funds for all banks. Because of the structural imbalance in the maturities of their assets and liabilities, thrift institutions would not be readily able to compete for higher priced deposits. The potential migration of thrift deposits to higher paying commercial banks would severely strain the already financially vulnerable thrift institutions, all of which are federally insured.

The higher cost of a reduced pool of deposits will result in much higher interest rates being charged to bank clients and consumers in general. The dramatic reduction in lending rates produced by the Section 936 deposits is clearly evidenced in a Puerto Rican government study of commercial lending rates and practices from 1975 to 1985. While in 1975 borrowers were paying an average of 3.46% above the prime rate, by 1985 they were only paying an average of .59% below the prime rate, or a 4.5% differential. This differential represents a savings to borrowers of over $112 million per year.

Higher borrowing costs would not be the only adverse effect of a massive withdrawal of Setion 936 deposits; the much-reduced lending base would force banks to restrict lending practices thereby effectively shutting off small and medium size, non-936 companies from access to affordable sources of credit. These restricted lending practices would unavoidably lead to a further contraction of economic activity and to higher unemployment in the sector that employs the largest number of persons - small business.

Adverse Effects on Public Financing

Current Puerto Rican Treasury regulations require banks to invest 20% of their daily monthly average of eligible Section 936 deposits in obligations of the Puerto Rican government or of its agencies and municipalities. Over $2 billion had been invested in these obligations as of December, 1984, substantially improving the marketability of Puerto Rico's obligations by increasing demand and reducing their cost. While these obligations were consistently priced to yield interest rates substantially above the Bond Buyers Index, the more recent issues have been priced to yield interest rates at or below said Index. This reduction in borrowing costs to the Puerto Rican Treasury amounts to approximately $32 million per year. Furthermore, this requirement has greatly enhanced the support for Puerto Rico's $8.75 billion of public debt, most of which is held by mainland U.S. investors throughout the nation.

Current Puerto Rican Treasury regulations also require that banks redeposit an additional ten percent of eligible Section 936 deposits with the Puerto Rico Government Development Bank. These additional resources have enabled the Bank to increase its earnings, reaching $48 million last year. The strengthened financial position of the Bank has allowed it to obtain better financing terms for public-sector financing, and to provide additional resources for small, promising private ventures which are unable to obtain credit within the island's financial system.

Finally, outright repeal of Section 936 could severely hamper Puerto Rico's credit in national markets. The loss of over $100 million in tollgate taxes would substantially affect government revenues. Because many companies would leave the island, the income of Puerto Rico's public corporations, such as the Puerto Rico Electric Power Authority and the Puerto Rico Water and Sewer Authority would be reduced, since the need for their services would be reduced. As Section 936 companies closed, the related economic activity would be reduced thus forcing a reduction in collections of municipal business fees and property taxes. All of these factors would weaken the capacity for public government authorities and municipalities to service their debt obligations thereby increasing the cost of carrying such obligations. Future capital improvement programs, employment and general economic activity would be severely hampered.

Section 936 and Employment in Puerto Rico

You will hear a great deal about the jobs in Puerto Rico that can be attributed to Secton 936. In its evaluation of Section 936, the Treasury Department focused only on direct employment in Section 936 companies. The members of our Steering committee with operations, some of them relatively small, in communities throughout the island have a clear picture of the effects on our economy of the salaries and fringe benefits paid by Section 936 companies to their Puerto Rican employees. Even the smallest retailer can attest to the importance that this steady, dependable volume of business has to the overal stability of his operations. Those firms, large and small, that supply the Section 936 companies with goods and services can measure effectively the multiplier effect of these sales. In evaluating the benefits of Section 936, it goes against common sense to ignore these linkages to other jobs in Puerto Rico. They are real -- and virtually important to an economy suffering from an unemployment rate of over 22 percent, over three times higher than the average rate in the U.S. mainland.

Section 936 and the Caribbean Basin Initiative (CBI)

Puerto Rico has accepted the responsibilities as well as the benefits of its commonwealth relationsnip with the United States. Our island is now largely integrated with the United States in economic, political, and cultural terms; yet we also retain a strong ethnic and cultural affinity with the peoples and lands of the Caribbean and Central America. We are profundly interested in contributing to the success of U.S. policies promoting the welfare of our neighbors.

Mr. Chairman, you and members of your committee played a key role in the successful effort to bring into being the Caribbean Basin Initiative. The trade, aid, and tax measures comprising the CBI form the centerpiece of U.S. policy to promote economic growth -- and, consequently, political stability -- in our region.

You may recall that Puerto Rico supported the CBI despite the direct threat posed by its removal of important economic protections and advantages. The threat is real; nevertheless, Puerto Rico seeks to contribute its own technical expertise, skilled labor, and monetary resources to the success of the CBI. Section 936 provides an essential underpinning to this effort.

A principal feature of our program for promoting the CBI is the fostering of "twin plants" in Puerto Rico and CBI beneficiary countries. Puerto Rico offers significant assets to firms contemplating investments in the region: a skilled, educated, and productive workforce; highly developed techinical and financial resources -- and the tax incentive offered by Section 936. Section 936 attracts investments in capital-intensive facilities that will operate in association with labor-intensive facilities located in CBI countries; it also generates revenues that can be used in part to finance projects in Puerto Rico. Governor Hernandez Colon has committed Puerto Rico to use $700 million of Government Development Bank funds to stimulate "twin-plant" investments; these funds are available because of redeposits by banks of Section 936 earnings in the Government Development Bank. The close proximity of the CBI nations to Puerto Rico and the regional expertise of our business people make feasible complementary investments to take advantage of these assets together with the low wages and duty-free treatment available in CBI beneficiary countries.

The possibilities of the twin-plant concept were recognized by this Committee last year, when it approved in the 1984 Trade and Tariff Act a customs provision essential to its success. Moreover, the business community also recognizes the potential: 21 major corporations have committed to investments in twin-plant facilities. As a banker, I can testify to the investment possibilities opened in Puerto Rico as a result of the CBI. Unfortunately, elimination of section 936 benefits will deal a serious blow to such plans.

Mr. Chairman, Puerto Rico responded to the economic threat posed by the CBI not by seeking special protections, but by conceiving a means of turning that important program into one of mutual benefit. The twin-plant concept and other CBI-related efforts can serve as important, visible instruments turning U.S. policy goals into practical sucesses. The demise of Section 936, however, would deprive Puerto Rico of an essential element of this strategy.

Thank you.

Puerto Rico
Manufacturers
Association

TESTIMONY
OF
MANUEL BORRERO
PRESIDENT, PUERTO RICO MANUFACTURERS ASSOCIATION,
BEFORE THE
SENATE FINANCE COMMITTEE HEARINGS
REGARDING THE
IMPACT ON THE ECONOMIC DEVELOPMENT
OF PUERTO RICO
OF THE CHANGES CONTAINED
IN THE PRESIDENT'S TAX REFORM PROPOSALS
AND THE
SUMMARY OF TAX REFORM OPTIONS FOR CONSIDERATION
BY THE COMMITTEE ON WAYS & MEANS
PREPARED BY THE STAFF OF
THE JOINT COMMITTEE ON TAXATION
OCTOBER 3, 1985

SUMMARY

- Section 936 of the U.S. Internal Revenue code has been demonstrated to be a key element in Puerto Rico's economic development. Section 936 companies have contributed basically, though not exclusively, within the sector generally referred to as high-technology. They have played a crucial role in the structural transformation of the economy. As the competitive edge of labor-intensive industries has been eroded, high-technology industries have become the major source of employment for the Puerto Rican labor force. The employment growth in high-technology has more than compensated the decline in labor-intensive industries and their real net income has grown 10 times faster than that of labor-intensive industries. Without high-technology industries Puerto Rico could not have achieved the growth rates registered by its GDP.
- Labor intensive industries continue to employ a sizeable amount of the manufacturing labor force even today; yet it would be erroneous to think that capital-intensive industries provide very little employment. In fact, they employ about the same number of workers as do labor-intensive industries, but contribute 7/10ths of the Island's industrial output.
- Section 936 industries also provide a significant leverage on the rest of the economy. Indirectly, they are high generators of employment and income in the other sectors of

the economy. Every direct job in the pharmaceutical industry, for example, is estimated to give rise to 3.62 additional jobs elsewhere in the economy; and every million dollar increase in its final demand can be expected to generate $1.86 million of income in the rest of the economy. The indirect effect on employment is much less in labor-intensive industries.

* The so-called Section 936 funds on deposit in Puerto Rico's eligible financial institutions play a significant part in encouraging construction activities and generating additional employment not only in the construction sector, but also in the financial and service sector. They provide funds for the construction of homes; they enable home financing at lower mortgage rates; they reduce the cost of borrowing by business and government; and they also reduce the financing charges for a series of worthwhile consumer needs.

* Given the decisive role Section 936 corporations play in the economy, the Section's repeal would result in substantially lower levels of real income and employment in Puerto Rico and cause overall living standards to decline sharply in a region which is an integral part of the United States. There is no doubt manufacturing operations can be expected to relocate out of the Island. Investment would decline; incomes and employment would be lost permanently.

Exports would be affected severely. The GNP growth rate would decline sharply. Direct employment in Section 936 companies would be reduced at least by one-half. Given the companies' high employment leverage, overall employment would decline and unemployment and migration to the U.S. mainland would rise dramatically. Per capita incomes would fall; Puerto Rico's economic standard as such and vis-a-vis the United States would deteriorate seriously; economic hardship would prevail. The damage would be irreparable.

* The wage credit scheme cannot be a substitute to repair the damage done by the repeal of Section 936. It would be an extremely complex and costly system to implement. It would be too limited for many corporations to continue operating on the Island, particularly, high technology industries, or to attract even labor-intensive operations to the Island, for it would not reduce labor costs sufficiently to enable effective competition with other developing countries where wage costs are much lower that the after-credit cost in Puerto Rico.

* The proposed repeal of the cost sharing option of allocating intangible income would deal a death blow to most of the electronics as well as many pharmaceutical companies operating on the island. It would penalize companies engaged in exporting and would effectively eliminate Puerto Rico's ability to attract a research and development capability to the island.

- Section 936 can bring additional prosperity to the Puerto Rican economy by using the accumulated earnings of Section 936 companies in the promotion of private enterprise in the Caribbean Basin through complementary operations between Puerto Rico and the Basin countries. This shared regional development strategy would finance crucial investment in the Basin countries; generate employment in Puerto Rico and in participating countries; would expand the exports of the Caribbean region and hence increase its foreign exchange earnings and assist in the repayment of their foreign debt; would get local entrepreneurs involved in economically viable manufacturing operations in their own territories; and would promote economic and social stability within the region.
- No growth strategy, however well conceived, can be promoted in an environment of uncertainty. The U.S. Treasury's repeated attempts to alter the functioning of Section 936 and the negotiations that led to changes in the rules of the game create a climate of utmost uncertainty which limits the effectiveness of the program. To sustain its economic growth, Puerto Rico must move aggressively to attract innovation-intensive industries which are most appropriate to the long-term development of the island's resources. Elimination of a climate of uncertainty is absolutely essential in order to attract such industries.

TESTIMONY
OF
MANUEL BORRERO
PRESIDENT, PUERTO RICO MANUFACTURERS ASSOCIATION,
BEFORE THE
SENATE FINANCE COMMITTEE HEARINGS
REGARDING THE
IMPACT ON THE ECONOMIC DEVELOPMENT
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PREPARED BY THE STAFF OF
THE JOINT COMMITTEE ON TAXATION
OCTOBER 3, 1985

My name is Manuel Borrero, President of the Puerto Rico Manufacturers Association, whose 1,350 members represent all sectors of the Puerto Rican economy. I am accompanied today by Mr. Hector Jimenez-Juarbe, Executive Vice-President of the Association, and by Attorney Joaquin A. Marquez, counsel to the Association.

The purpose of my testimony is to bring to you the message from all the members of the Association that the current income-based tax credit provision of Section 936 of the U.S. Internal Revenue Code should be preserved as is. Its repeal will ravage the Island's manufacturing sector. Given the sector's leverage and linkages within the island's economy, repeal of Section 936 will deal Puerto Rico a devastating blow from which it will be hard to recover. It would also hinder the opportunity to bring growth and development to the economies in the Caribbean. The damage will be irreparable, and cannot be undone by the wage credit scheme which is proposed as an alternative.

I. Section 936 has worked and is working.

During the three-and-a-half decades of economic development, the manufacturing sector in Puerto Rico has responded vigorously to the incentives offered by the Island's fiscal policy which was devised to complement the preferential tax treatments granted by the U.S. Internal Revenue Code. Because the supply of unskilled labor was relatively abundant and the wages were low, labor-intensive industries were the initiators of our process of growth. However, the success of the economic development program prompted skills to increase and wages to rise. Institutional factors also caused our wages to rise. Moreover, the major export market for our goods, the United States, began to liberalize the importation of products originating in foreign countries where labor costs and regulatory requirements were much lower. Our labor-intensive operations began to lose part of their comparative advantage and their growth began to slow down. We began to lose some of our labor-intensive operations through relocation to other countries.

As a result, we began shifting our resources to new areas of growth. The new era of capital-intensive industries maintained our manufacturing sector on its rapid growth path and made it the principal employer in our economy. But then, we faced once again a series of adverse circumstances, which further eroded our competitive edge.

First, rapidly escalating petroleum prices raised the Island's costs of production, closed the doors to high energy consuming industries, and raised maritime shipping rates. As you well know, maritime transportation is vital to our exports and imports. Second, the Island's minimum wages was automatically increased to equal rising levels on the mainland; this further reduced whatever labor cost advantage we might have had. To top it all, the U.S. economy went through a long period of stagflation followed in the early eighties by the longest and severest economic downturn ever experienced since World War II. These effects were equally reflected on the Island.

Puerto Rico overrode these obstacles by adapting to the changing circumstances. To be sure, our light and labor-intensive industries continued to lose the vital role they once played in our economic progress. However, we replaced these losses with high-technology industries which began to generate employment in increasing numbers, and income at increasing rates. By 1984, we had 584 establishments employing 68,444 workers producing drugs, chemical products, electrical and electronic equipment, machinery and instruments, rubber products and plastics, and refining petroleum. These industries represented 28% of total manufacturing establishments and 45% of total manufacturing employment.

If we look at the manufacturing sector's performance since 1976, we observe employment losses in many low-technology industries, which, however, have been more than compensated by employment gains in high-technology industries. While employment in other manufacturing subsectors fell by 12.5% from 1976 to 1984, employment in Section 936 high-technology industries rose by 44% during the same period. Today they employ about the same number of workers as do labor-intensive industries. At the same time, high-technology industries have raised their share to 70% of the Island's industrial output. This enhanced performance is reflected in our merchandise exports, 60% of which consist of high-technology products. These industries have given a strong impetus to the Island's exports, which have increased at the annual rate of 13.3% since 1976. This is a dramatic performance that few countries can match.

There is no doubt, therefore, that Section 936 has had a tremendous direct impact on our Island's economy: today Section 936 companies are estimated to employ around 90,000 workers; they generate the overwhelming part of our industrial output and their products make up 60% of our merchandise exports. The impact is not confined to the manufacturing sector, but is spread to the rest of the economy through intricate inter-industry linkages. These linkages account for their high-employment and income leverage on the rest of the economy.

It is estimated that every new job in manufacturing as such gives rise to 2.41 jobs in the other sectors. However, the employment multiplication coefficient of many Section 936 companies are much higher than the industry average. Every new job in the pharmaceutical sector, for example, is estimated to give rise to 3.62 additional jobs; in machinery production the figure is 3.65. The island-wide spread of job opportunities characteristic of these industries expresses their decidedly positive contribution to the Puerto Rican economy.

The same holds for their generation of income throughout the Island. High-technology industries pay higher average wages than the average in manufacturing. Their high payroll volume and their greater linkage to the rest of the economy enhances strongly the incomes of other industries and sectors. Taking the case of the pharmaceutical industry once again: every million dollar increase in the demand for its products adds $1.86 million to incomes generated in other sectors.

I would, therefore be totally justified in stating that coupled with our own fiscal incentives on the Island, Section 936 has been a key element in our economic progress. Our industries have succeeded in expanding their own employment, output, and exports at a fast rate; they have thereby indirectly generated employment and income in the economy as a whole; and have been powerful instruments in the rise of the Island's living standards.

II. Section 936 increases the capital pool of loanable funds.

As you well know, Section 936 exempts interest income received from "Qualified Possession Source Investment Income" as long as it does not exceed a given percentage of the corporation's gross income. Such incomes, which have come to be called Section 936 funds, form an important part of the deposit base of the Island's financial institutions. As of July 31, 1985, commercial banks had $6.8 billion of such funds on deposit, savings and loan associations had $2.7 billion, and brokerage houses had some $2.1 billion.

The use of 936 funds is regulated by both Puerto Rican and federal regulatory authorities. According to local regulations, 20% of the funds are to be invested in Puerto Rican Government securities; an additional 10% must be put on deposit at the P.R. Government Development Bank; and 7% is consigned to construction loans, and housing and commercial building mortgages. The remaining 63% has to be placed in eligible loans and assets in accord with the regulations. These could be short or long-term business financing; loans to households for home improvement or construction and medical expenses; loans for commercial transportation vehicles; education loans to students; loans to install energy-saving equipment, etc.

By exempting from tax the interest paid on these deposits, Section 936 has been instrumental in providing the Island's economy with an adequate supply of loanable funds at lower than market interest rates. With a 30% share in total 936 funds, the Puerto Rican Government has been able to meet the needs of its Central and Local Governments, agencies, and public corporations. Recently it has issued $220 million of Mortgage Trust bonds to finance the construction of some 5,000 low cost housing units per year at lower than market rates. The activity is expected to generate 18,000 direct and indirect jobs.

III. Section 936, maintained as it is, can help bring further prosperity to Puerto Rico and to the Caribbean Basin.

The Government of Puerto Rico has announced an ambitious plan to share the Section 936 funds on deposit at the

Government Development Bank to uses that enhance the effectiveness of the far-reaching program adopted by U.S. Congress with the Caribeean Basin Recovery Act of 1983.

The Caribbean Basin Initiative is a program that aims at promoting private sector economic development in our region through trade concessions and limited fiscal incentives: duty-free access to the U.S. market for most of the Basin's products; tax credits to U.S. private investment; and assorted technical assistance.

The shared regional development strategy proposed by the Government of Puerto Rico makes use of part of the accumulated funds and offers financing on favorable terms for new plants in Puerto Rico to corporations willing to invest their own funds in twin plants or other complementary projects in a Caribbean or Central American country. Contingent upon the retention of Section 936, $840 million of balances currently on deposit in the Government Development Bank will be available at reduced interest rates for long-term loans to corporations starting an integrated twin plant operation.

The complementarity between Puerto Rico and the Caribbean is obvious. Labor costs in the Caribbean are significantly lower than in Puerto Rico. The scheme implies setting up processes of production according to comparative cost advantage. Hence, processes which are more labor-intensive and low skill requiring would be executed in the Caribbean; the product would be exported to Puerto Rico (United States) where the processes requiring higher and more costly labor skills would be carried out. Presently this is quite beneficial to a great part of the Caribbean where skilled labor is not abundant. But the complementarity need not stop at labor costs; it could apply to various aspects of production, such as the availability of raw material, the presence of appropriate infrastructural facilities, etc.

The scheme represents a form of development assistance with mutual benefits of economic growth, export expansion, and employment generation. It provides financing for crucial investment; it generates employment in Puerto Rico as well as in the participating country; it expands the exports of the Caribbean region to the United States; it increases the Caribbean's foreign exchange earnings and helps solve the region's troublesome debt problem; it gets local entrepreneurs involved in economically viable manufacturing operations in their own territories; in short, it promotes economic growth and social stability in a potentially turbulent neighboring region.

IV. The repeal of Section 936 will undo all that has been achieved in Puerto Rico during the past decades.

First and foremost, manufacturing operations would relocate out of Puerto Rico. A brief survey our Association conducted among its members concluded that 40% of the responding U.S.

corporations with 936 manufacturing subsidiaries would relocate out of the Island, and not necessarily to mainland United States, but to foreign destinations. A large percentage of the companies not covered by the Section indicated that they too would abandon the Island entirely or partially with radical alteration in their operations.

We have a labor cost disadvantage in labor-intensive industries vis-a-vis many other competing locations. Our labor costs in apparel manufacturing, where employment has kept declining over the years to its present level of about 30,000, are eight times as high as in the Philiipines and five times as high as in Haiti of Jamaica. Labor costs in fish packing are ten times as high as in the Dominican Republic. Our production costs in electronics are almost as high as they are in the United States and definitely higher than in Malaysia and the Dominican Republic, mainly because our electronics industry pays higher wages to its workers. Obviously, our labor costs are competitive with industrialized countries, but far exceed those in many developing countries.

Given our relative disadvantage in the high cost of labor, our Island becomes a highly desirable location for relatively capital-intensive industries. Hence, our tax incentive system combined with the duty free access to the United States and tax-free repatriation to the mainland, justify in compensating our Island's pre-tax cost disadvantage.

To take away the income based tax credit would leave very little incentive for firms with low fixed investment levels to remain in Puerto Rico. Firms with the highest fixed investment levels cannot be expected to relocate immediately, should Section 936 be repealed; but they would discontinue all expansion plans and would not replace current capacity as it became obsolete. They would move their high profit margin products to offshore locations with more favorable tax incentives.

As a result, investment in manufacturing would decline; production would be scaled back drastically; exports would shrink, followed by permanent loss of employment and income. It has been estimated that in most industries exports and employment would decline by 50% in five years; in some the decline could be as high as 90%. The Island's output growth would decline drastically. Direct employment in Section 936 companies would fall to almost half their 1985 level. Given the companies' high employment leverage on the economy as a whole, overall employment would fall. Hence, unemployment, which currently is over 22%, would rise sharply. One estimate puts the increase at 10 percentage points. As a consequence, real per capita income (in 1985 dollars) would fall.

The repeal would also shrink the capital pool accumulated in Puerto Rican banks. Commercial banks would not only lose 936 funds, but will also find it difficult to replace them.

Any replacement of the lost funds would carry a higher cost and produce a rise the interest rates. As a corollary the cost of money would rise throughout the economy of the Island by perhaps 2-3 percentage points on the average. Simultaneously, because of the Island's severely limited economic growth and decline in its general economic conditions, lending activity cannot be sustained at its present level. Further employment losses would occur in the financial sector adding to the overall decline in incomes.

It is obvious that the repeal of Section 936 would cause a serious deterioration in Puerto Rico's economic standards as such and vis-a-vis the rest of the United States. While incomes would rise in mainland United States, our Island would regress into the economic hardship from which the far-sighted tax incentive legislation of the past rescued us.

The damage of the repeal to the economy would be irreparable. Section 936 is crucial to any long-run solution of the Island's unemployment and essential to its ability to continue to share the U.S. economic prosperity. Real incomes and employment would decline drastically and the levels of living would decrease accordingly. The repeal would not be fair and equitable; nor would it encourage growth.

The repeal would also stifle the potential benefits of the shared regional growth strategy to be financed out of the Section 936 funds. Without the operations that would provide the funds for this particular pool, no impetus will exist to set up complementary operations in Puerto Rico and the Caribbean Basin countries. The chance for a stable and peaceful growth in the Region will have been missed.

V. The wage credit scheme cannot be the substitute of Section 936 nor can it repair the damage Section 936's repeal would cause.

As proposed, the wage credit would be 60% of the Federal minimum wage paid to employees of establishments engaged in manufacturing, plus 20% of such wages paid above the Federal minimum, subject to an overall wage cap per employee of four times the Federal minimum.

Leaving aside the accounting and administrative complexities the scheme would introduce, the reduction in labor costs it proposes is much too limited for many corporations to continue operating on the Island or to attract labor-intensive industries to the Island. I have already mentioned the labor cost differentials between Puerto Rico and other competing areas in the manufacture of a number of items. The wage credit remuneration is far higher than the cost of labor in competing countries like Haiti, Costa Rica, Panama, Taiwan, Hong Kong, and South Korea.

It would be presumptuous to expect the present wage levels to be reversed to their low prior levels. They are the outcome of developments on separate arenas, one of which is Federal labor legislation and the other, the structural transformation in our manufacturing towards higher remuneration. It would be just as presumptuous to expect that wage costs in competing locations will have caught up with the levels in Puerto Rico in a reasonably short time to eliminate all danger of competition.

The wage credit scheme cannot possibly be an instrument of growth and development for the Island. If anything, it will put Puerto Rico into the strait jacket of having to rely solely on labor-intensive industries, which, given the institutional arrangements that determine the level of wages on the Island and the limits of the wage credit scheme, would mean the loss of industries to other areas more favorable to investment, hence economic decline rather than growth. At the same time, the shift from Section 936 to the wage credit scheme would deny Puerto Rico the technological development and modernization that came to be achieved under Section 936 and that can continue with it, since such developments take place in relatively more capital utilizing industries. Therefore, Puerto Rico would lose on both counts and the spread of living standards between Puerto Rico and the United States would widen.

Changes in world markets and in Puerto Rico's own economic structure, molded as it is by its integration into the United States economy, leave no alternative but to press on with manufacturing operations that embody high technology levels. A wage credit scheme is not the means by which to achieve this aim.

VI. Section 936 must be preserved as is.

The Summary of Tax Reform Option for Consideration by Committee on Ways and Means prepared recently by the staff of the Joint Committee on Taxation has supported the preservation of Section 936 subject to two modifications. The first relates to the method of allocating income from intangible property among the mainland corporations and their manufacturing subsidiaries on the Island; the other limits the exemption for passive income. Both seek to increase the U.S. corporate tax liability related to manufacturing activities in Puerto Rico; neither is a realistic alternative to Section 936, since they both cause substantial reductions of employment and economic contraction on the Island.

The Joint Committee proposes to repeal the cost sharing method of determining the income covered by the Section 936 credit. This method was enacted three years ago and works as follows.

In computing the income covered by the Section 936 credit, a Section 936 company can earn a full return on the intangibles involved in manufacturing the product. It may also claim a full refund with respect to marketing intangibles if these are developed solely, and owned, by the Section 936 company in Puerto Rico or if the ultimate consumption of the product takes place in Puerto Rico. To use the cost sharing method the company must pay its share of the research and development cost incurred by its affiliated group.

The alternatives to the cost sharing method are the cost plus method and the profit split method. In the former, the Section 936 credit applies to profit of no more than 30% of the manufacturing costs incurred. In the latter, the credit applies to 50% of the profit from the product (including manufacturing and marketing intangibles); the Section 936 company is then charged with its share of ongoing research and development costs in an amount no less than 50% of what would have been its cost sharing payment.

The advantages of the cost sharing method and the reasons why it is attractive to many companies are the following:

1. Under this method, a Section 936 company is subject to the general intercompany pricing rules (except with respect to manufacturing intangibles which are allocated to the Section 936 company in exchange for the cost-sharing payment) provided in Section 482 which determine the profit properly attributable to the operations conducted in Puerto Rico. The operation of these rules motivate Section 936 companies to integrate their operations in Puerto Rico and thereby generate additional employment locally.
2. The cost-sharing rules allow a Section 936 company to claim ownership of intangibles developed in Puerto Rico and allow a credit against the cost-sharing payment for the cost of product area research paid

solely by the Section 936 company. This rule stimulates the transfer of research and development functions to Puerto Rico and the transfer of functions related to the development of marketing intangibles.

3. The cost plus and profit split methods are in many cases too restrictive and inflexible for determining a reasonable profit allocable to the manufacturing operations conducted in Puerto Rico. For many companies, these methods may not generate a sufficient tax incentive to locate their operations in Puerto Rico.
4. The cost-sharing method is not arbitrary. Under it, an electing Section 936 company is required to make annual payments to the members of the affiliated group in connection with the research conducted by them with respect to the same product area as that in which the Section 936 company conducts its activities. In exchange for such payments, the 936 company is treated as the owner of the intangibles associated with the production of the possession products, such as patents, formulae, processes or know-how, and is allowed a return therefrom. By sharing in the costs incurred in the product area research, the Section 936 company is paying for the intangible it uses in the manufacture of its products.

5. If Section 936 companies are not allowed to use the cost-sharing method to determine their creditable income, they would be, in effect, at a more disadvantageous position than their foreign counterparts. An Ireland affiliate which does not employ U.S. citizens and whose profits serve to increase the U.S. trade deficit, is able under the 482 regulations to enter into a cost-sharing agreement with other affiliates for the development of intangibles. In exchange for its share of the costs associated with the development of the intangible, it will receive an interest in such intangible, enabling it to derive a return therefrom. Under certain circumstances, the above situation could result in a disincentive for locating manufacturing operations in Puerto Rico, transferring much needed jobs to foreign jurisdictions.

Many 936 companies, even those not in the high-technology group, such as textiles, have opted for cost sharing, even though they do not have significant intangibles. They have found cost plus much too limiting. Companies in the field of electronics, with little or no marketing intangibles, have also opted for cost sharing, because they have found the profit split inappropriate when operations rely on the price and quality of the products rather than trade names or marketing intangibles.

Repeal of the cost sharing option will also deny Puerto Rico the possibility of attracting research and development activities to the Island by eliminating a powerful incentive for companies to conduct such activities there. This would be a cruel blow to the hopes and aspirations of many recent graduates in the natural or physical sciences who eagerly await the opportunity to employ their skills and knowledge in new laboratories to be set up by companies electing the cost sharing option.

Hence, the repeal of cost sharing may do more damage than good, for it would take away the incentive to do business in Puerto Rico both from labor incentive industries as well as high-technology industries, the very ones which directly or indirectly bring great economic benefits to the Island.

Taxing the interest income received on Section 936 deposits with Puerto Rico's financial institutions would similarly have adverse effects on the Island's industrialization and growth process, for it would limit the pool of funds available for a series of investment and construction loans, not to mention their use for the improvement in homeowning equity, human capital formation, and other standard of living-raising purposes. I have already referred to these benefits; they would all be drastically reduced.

VII. Summary and Conclusions

I should like to end my testimony by stressing once again that our Island's continuing industrial development hinges upon the maintenance of the favorable economic climate currently available to potential investors. Our past experience is the best evidence of how successful we have been in promoting our industrial development. To continue this success we must be able to demonstrate to potential investors that there is a high degree of certainty that the current favorable conditions will be maintained for the forseeable future.

It is impossible to promote any growth strategy in an environment of uncertainty. Entrepeneurs must rely on a steady flow of materials and inputs, must count on reliable factors of production, must be reasonably sure of the marketability of their products, of deriving the benefits of their operation, of the continuity and the certainty of the rules of the game which prescribe the institutional and social climate within which they are to operate. Beginning with the negotiations that led to the TEFRA amendments to Section 936 in 1982, the climate of continuity and certainty of the rules of the game has been eroded and undermined in Puerto Rico. The introduction of this element of uncertainty has adversely affected investment decisions by Section 936 companies and other companies which may have been attracted to Puerto Rico.

Today, our economic horizons are cloudy once again. We are unable to tell the investors what to expect with respect to the tax rules that govern our manufacturing operations. As a result, we are experiencing difficulties in our manufacturing sector. Since December 1984, employment in plants promoted by the Economic Development Administration has been declining at an increasing rate over its levels in the same months of the previous year. Granted, one factor alone cannot be held responsible for the performance of our manufacturing sector, especially when adverse developments in the U.S. economy such as the high exchange rate of the dollar, also take their toll on our operations. However, it cannot be denied that the uncertainty surrounding the Section 936 issue adds to the aggravation caused by the already existing adverse conditions.

To sustain our economic growth, we must move aggressively in attracting technology, design, and marketing intensive industries which promise long term development potential for our people. To achieve this goal, we must offer such industries a climate of certainty that current rules will not soon be changed. On behalf of all manufacturers of Puerto Rico, I ask, therefore, that Section 936 be left unchanged, so that altogether we may be able to continue to show to the world that our Island is still the showcase of growth and development.

Thank you.

STATEMENT OF THE SOUTHERN ELECTRIC SYSTEM
ON THE PRESIDENT'S TAX PROPOSAL
TO THE CONGRESS FOR
FAIRNESS, GROWTH AND SIMPLICITY

TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

October 1, 1985

STATEMENT OF THE SOUTHERN ELECTRIC SYSTEM
TO THE COMMITTEE ON FINANCE

October 1, 1985

The Southern Company is the parent company of four operating electric utility companies. The operating companies are Alabama Power Company, Georgia Power Company, Gulf Power Company and Mississippi Power Company. Together these four operating companies are informally referred to as the "Southern electric system" and, on a combined basis, serve over 2.8 million retail customers in a 120,000 square mile area consisting of the major portion of Georgia, central and southern Alabama, northwest Florida and southeast Mississippi. These four companies have a total generating capacity of 28,593 megawatts and currently have under construction a total of 4,970 megawatts of new capacity.

The Southern electric system supports the need to reform and simplify the tax laws to achieve equitable taxation. However, we do not believe that capital formation incentives are expendable items in this process. Capital formation incentives are a vital source of capital to the Southern electric system and other capital intensive industries in the United States. The existing tax depreciation system and the investment tax credit have provided critically needed internal cash flow to the Southern electric system, and are the most notable capital formation incentives for electric utilities. Before repealing any capital formation incentive, we urge Congress to consider carefully the impact that such repeal would have with respect to economic growth, jobs, and international competition.

Because the President's proposal retains one of two vital capital formation incentives to the Southern electric system, we support his proposal. The President's proposal would repeal the investment tax credit, but would retain a favorable tax depreciation system - the capital cost recovery system (CCRS). It is our view that any further erosion of capital formation incentives which are presently contained in the President's proposal would produce a tax reform proposal which could not be supported by us and many other capital intensive businesses.

The main features of the President's proposal that would impact the Southern electric system are as follows:

(1) the corporate income tax rate would be reduced to 33% from 46%;

(2) a new system of tax depreciation would be provided - the capital cost recovery system; and

(3) the investment tax credit would be repealed.

Notwithstanding the repeal of the investment tax credit, the corporate tax rate reduction from 46% to 33% in conjunction with the proposed CCRS tax depreciation system would benefit our customers by reducing the cost of electricity (about 5% for the period 1986-1996). If the benefits to electric utilities under the proposed CCRS tax depreciation system are materially reduced by an amendment to the President's proposal, the cost of electricity to our customers would increase rather than decrease. In this case we could not support such an amended proposal.

The fact that the Southern electric system supports the President's proposal as now stated does not mean that the Southern electric system would not be adversely impacted. Under the President's proposal, internal cash flow to the Southern electric system would be reduced by about $1.5 billion through the year 1995 and by about $5.1 billion by the end of the year 2000. This is a large price to pay for reform and simplification. The largest contributor to the reduction in cash flow is the repeal of the investment tax credit.

The Southern electric system is located in an area (Southeastern United States) that is part of the so-called "Sun Belt" which has been projected by many to have the greatest economic growth in the nation. In order to provide an adequate supply of electricity to the expanding economy of the Southeast, the Southern electric system has projected that it will require for the period, 1985-1995, about $4.0 billion of additional debt and equity capital in order to finance needed electrical facilities.[1/] The loss of internal cash flow under the President's proposal would increase the requirement for additional debt and equity capital to about $5.5 billion, or a 38% increase. An increase of 38% in capital requirements, obviously, produces a great impediment in meeting the future demand for electricity in the Southeastern United States. Any

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[1/] While the Southern electric system is pursuing conservation, load management, solar technology, and cogeneration projects, it is apparent that, in the long run, these resources will not completely replace the need for larger central station power plants in order to meet the demand for electricity in the late 1990's.

further erosion of capital formation incentives would compound this impediment.

We urge Congress to review carefully the vital need for capital formation incentives, and to retain intact the proposed CCRS tax depreciation system which is included in the President's package.

Set forth below are our specific recommendations regarding certain provisions of the President's proposal.

CCRS

The Southern electric system supports the concept in CCRS which would give equal treatment relative to investment incentives for all assets for all industries. This concept is consistent with the theme in the President's proposal which is intended to create a "level playing field" for all investments for all taxpayers.

Although historically tax incentives for investment have been biased against public utility property, there is no economic or other reason that justifies excluding regulated industries from federal programs to stimulate investment. The tax law should not be used to make the capital cost of goods produced by a regulated firm arbitrarily higher than that of goods produced by an unregulated firm. To the extent that investment incentives continue to exist, the public utility industry should be granted complete and equal access to them.

To provide a neutral investment incentive in the CCRS tax depreciation system, the President's proposal sets depreciation rates and recovery periods to produce an effective tax rate of 18% on the income from new investments in all types of machinery and equipment. Based on recent studies for the electric utility industry, the real effective tax rate on the income from new investment in utility property under CCRS would be about 22% - 24%. Although this is above the President's target rate of 18%, the difference or bias is much less than the bias that has existed in prior years.

Normalization

The benefits to the electric utility industry under CCRS would contribute to capital formation only if such benefits are normalized consistent with rules in existing law and in the President's proposal. Normalization would allow the Southern electric system to compete on a more level playing field in the capital markets and with other providers of energy. Normalization therefore should be treated as part of the concept of investment neutrality.

We are pleased that the President's proposal recognizes the need for normalization provisions similar to those in present law. Normalization should be required for the tax effect of the timing differences between CCRS depreciation without inflation adjustments and straight-line depreciation of the tax basis of property. Should these normalization requirements be violated, use of CCRS depreciation should not be permitted. Such rules would assure a sharing between a utility's shareholders and customers of the benefits of CCRS.

Investment Tax Credit

The repeal of the investment tax credit would be particularly detrimental to the Southern electric system. The credit has provided an important source of capital to help finance the construction of needed electric generation, transmission, and distribution facilities. The loss of the credit would require significant increases in external financing.

Several aspects related to the repeal of the credit need to be addressed. Our major concerns are the absence of transitional provisions and the regulatory treatment of unamortized credits.

As drafted, the proposals would repeal the investment tax credit for any property placed in service on or after January 1, 1986. However, the President's proposal anticipates that Congress will provide reasonable and appropriate transitional rules with respect to the investment tax credit. To change the rules in midstream by failing to provide reasonable and appropriate transitional rules would be unfair because it would result in the elimination of a substantial source of financing for multi-billion dollar projects that were entered into, and for which funds have been committed, in reliance on current law.

Transitional rules similar to those, when the investment tax credit was repealed in 1969, should be provided. Specifically, the "binding contract" rule should be adopted. This rule would allow investment tax credits to be claimed on all property for which binding contracts were entered into before the effective repeal date. These transitional rules should apply whether or not the investment tax credits have been taken on qualified progress expenditures during construction.

If the investment tax credit is repealed, there should be a continuing normalization requirement for credits of regulated companies. There should be a penalty for a violation of the terms under which the credit was initially permitted. The penalty should be sufficiently severe to be a deterrent to such violations. For example, a two-part penalty in the event of a violation of section 46(f) of the Code could be provided. The first part of the sanction should be a disallowance of the investment tax credit for all "open" taxable years (if any) in which the credit was taken under the law then in effect. The second part of the penalty should be the recapture of the remaining unamortized balance of investment tax credits to the extent such amounts are attributable to property subject to section 46(f) of the Code. The recapture under the second part of the sanction should occur as of January 1 of the taxable year of the violation.

The continued sharing of the investment tax credit between customers and shareholders would reflect the intent of Congress in enacting the credit.

Capitalization of Construction Period Interest

The Southern electric system is concerned with the method in the President's proposal for capitalizing construction period interest and other construction overhead costs. According to the President's proposal, construction-period interest would be defined to include any interest expense of a taxpayer that could be avoided if construction expenditures were used to repay indebtedness. This incorrectly assumes that 100% of construction is financed by means of borrowed funds. While this assumption may or may not be true with respect to nonregulated businesses, it can be stated without equivocation that this is not true for regulated electric utilities.

The regulatory accounting rules of many jurisdictions already require full or partial capitalization of financing costs on projects involving significant construction periods or costs. These rules recognize that both debt and equity capital is required to finance construction. We urge that the tax rules recognize that debt and equity is required to finance construction projects. Thus, only a portion of a construction project would be subject to the capitalization rules. That is, only interest, which is related to the portion of the construction project which is financed with debt, would be capitalized.

We also urge that a "deminimus rule" be included for small-dollar projects and short-duration construction period projects.

Employee Benefits

The President's proposals that deal with employee benefits are a major concern to the Southern electric system and our employees. We believe that some aspects of the proposals would so hamper efforts of both employers and employees to provide for adequate retirement funds that sufficient retirement income would become less attainable through private plans and the burden on government could increase significantly.

The problems our nation has experienced with the Social Security system clearly indicate that increased reliance on the government sector is not desirable.

The proposed annual $8,000 cap on the amount of an employee's contribution to a qualified cash or deferred arrangement is unrealistically low for many employees. Any cap should be expressed as a percentage of income to provide all employees an equal opportunity to have supplemental retirement income in proportion to their earnings. The inclusion of any IRA contribution in arriving at a cap would be unworkable when applied at the employer level.

Excise tax penalties on benefits paid under qualified retirement plans prior to attaining age 59-1/2 in many instances would deter employees from retiring at an earlier age in accordance with existing plan rules. Equity dictates that excise taxes not apply to any payment from a qualified plan by reason of retirement at any age.

The ten-year averaging tax calculation for lump-sum distributions has encouraged many employees to set aside funds for retirement and should be retained.

The existence of employer-provided health insurance is an example of a privately sponsored program that decreases the dependence upon governmental assistance for providing health care. We believe that imposition of the income tax on employer-provided health insurance premiums may discourage employees from participating in such programs and would establish a dangerous precedent.

85-4

Policy Position Regarding

THE IMPORTANCE OF SECTION 936 TO THE SOUTH AND THE NATION

Submitted by: Governor Bob Graham, Florida

Adopted at the 1985 Annual Meeting of
The Southern Governors' Association
September 10,1985

The U.S. has recognized that the Caribbean is an important area of the world by enacting the Caribbean Basin Initiative (CBI). Special trade and tax advantages have now become law in order to encourage the private sector, spur economic development, and to help insure political stability of eligible Caribbean countries.

That same idea has been embodied in the nation's tax code for over fifty years for American citizens living in Puerto Rico. This provision, Section 936 of the Internal Revenue Code, which provides a tax credit for income earned in Puerto Rico, is responsible for encouraging U.S. firms to locate in Puerto Rico, spurring the island's economic development, and aiding in the continuance of political stability.

There are great parallels between the economic history of Puerto Rico and that of the South as a whole. The changes wrought over the past quarter century have turned both from rural, labor intensive agricultural areas into urban, high technology centers. Because of proximity, the two-way trade between Puerto Rico and the Southern states has resulted in jobs and income in both locations. Ultimately, this translates into benefits for the nation.

The current tax reform plan proposes to alter Section 936 in such a way as to discourage continued investment in Puerto Rico. Coming at a time of budget retrenchment, this proposal will further harm Puerto Rico, and by extension the South and the rest of the nation. It would present the perplexing problem of having the federal government extending benefits to Caribbean nations while reducing benefits to a part of America in the same geographic area. Finally, the proposed change would make difficult Puerto Rico's own initiative to use 936 monies as a special loan fund for CBI twin-plant manufacturing, with part of the work taking place in Puerto Rico and part in the individual beneficiary country.

Therefore, be it resolved that the Southern Governors' Association opposes any change in the current language of Section 936 of the federal tax code.

Position Statement of
William T. Esrey
President and Chief Executive Officer
United Telecommunications, Inc.

My name is William T. Esrey. I am President and Chief Executive Officer of United Telecommunications, Inc. (United Telecom), a Kansas based telecommunications holding company.

United Telecommunications, Inc. strongly supports deficit reduction, fairness in our tax law, and a tax code which supports economic growth. However, we believe that current tax reform proposals would seriously handicap American business and thereby threaten our fragile economic recovery. Thus, these proposals would disserve a major goal of tax reform.

United Telecom has begun constructing a $2 billion nationwide digital-switched fiber optic network which, when completed in 1988, will bring superior quality integrated voice, data and video communications services to every community in the nation.

Construction of this project commenced on the assumption that the Investment Tax Credit/Accelerated Cost Recovery System (ITC/ACRS) aspects of our current tax code would continue. Loss of these provisions would jeopardize thousands of jobs and construction contracts. Continuation of these projects would produce substantial tax revenues for the U.S. Treasury. Completion of these projects would also bring to Americans enhanced services at lower cost, thus improving America's productivity and enabling us to compete more effectively in the world economy.

United Telecom is particularly concerned about the current Tax Reform proposals' drastic curtailment of capital formation incentives through the elimination of the ITC and the adverse changes in the ACRS depreciation rules. The ITC and current ACRS rules place American business at roughly the middle of such incentives relative to our major foreign competitors.

The ITC in particular has been an effective stimulant to productivity-enhancing capital formation in the United States. In the case of United Telecom, its elimination would make uneconomic some of our current construction projects. This is undoubtedly true for many other American businesses whose investment projects would benefit our economy.

If the ITC is to be eliminated, however, we believe that gradual transition rules are critical. In general, we believe there is a compelling need for a reasonable transition period in implementing any major tax reform.

United Telecom also is concerned about the excess depreciation recapture (the so-called "windfall" or "penalty") payment provision. This provision is retroactive and unfairly burdensome for capital intensive companies.

United Telecom's more detailed positions on various provisions of the Tax Reform proposals are as follows:

1. ITC/ACRS AND LOWER CORPORATE MARGINAL TAX RATES

   If the ITC is to be repealed, we suggest that at a minimum there be a provision grandfathering qualified master projects or qualified in-progress projects for ITC treatment pending completion of such projects. This would significantly minimize the disruptive impact of such a major change in our tax structure. Another responsible alternative would be a two-year transition period during which ITC/ACRS would be largely preserved until significantly lower marginal tax rates are phased in effective in 1988.

2. ACRS* (Current)/RCRS* (Treas. I)/CCRS*/Jt. Tax Options*

We generally find the CCRS proposal more appropriate in the overall context of tax reform than RCRS (or the even less reasonable Joint Tax Committee staff options), in part because of the essential indexing feature.

Nonetheless, specific clarifications and improvements in CCRS have been sought by United Telecom, United States Telephone Association (USTA) and others. For example, computerized central office equipment, which today is five year recovery property, should more properly have been categorized under CCRS class 2 (five year recovery property, e.g., computer equipment) rather than the slower depreciation class 4 (seven year recovery). This has been recommended in the option proposed by the Joint Tax Committee staff in its spreadsheet released on September 26, 1985. However, outside telephone plant equipment (currently fifteen year property) is proposed at thirty years by the Joint Committee staff, while the President's proposal would classify such property at ten years. So, fiber optic electronics, a rapidly changing new technology, would be designated as ten year property in one proposal and thirty year property in another. The fiber optic industry, while relatively new, is already undergoing significant technological change. Its rate of obsolescence is rapid and, therefore, its rate of depreciation should realistically be shorter, as under the President's proposal, not longer as the staff of the Joint Tax Committee proposes.

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* Accelerated Cost Recovery System/Real Cost Recovery System/Capital Cost Recovery System/Joint Committee on Tax Staff Options

3. Excess Depreciation Recapture

The so-called windfall tax (or what more accurately should be called the "excess" depreciation recapture tax) should not be adopted by Congress because its retroactive feature is unfair, complex, and discriminates heavily against capital intensive businesses such as communications industry companies. This provision would penalize United Telecom and its subsidiary companies' ratepayers for investing in new equipment from 1980 through 1985. Consequently, we strongly oppose this proposal.

Perhaps even more important, the retroactive taking away of tax incentives (depreciation deductions) upon which businesses relied in making major investments (which stimulated our economy), would set an adverse precedent with respect to Government credibility in tax matters, having potentially negative consequences on future investment decisions.

4. Normalization

Normalization rules for regulated utilities under CCRS should, as proposed, continue to be comparable to those under ACRS. In addition, normalization rules should be retained for the unamortized portion of ITC allowed to regulated public utilities. Under these rules, tax benefits would be used to reduce utility rates over the useful life of the assets. Therefore, future ratepayers would not be disadvantaged by artificially lower rates for today's ratepayers. However, there are several technical, but very important, normalization issues raised or not resolved by the President's Tax Proposals (PTP).

The following are our recommendations to deal with these important issues:

a. Under the PTP, neither of the components* of the annual depreciation expenses allowed under the new CCRS depreciation system should be flowed through immediately to ratepayers.

b. For purposes of the ITC, the penalty clause** provided under present law must be extended and modified to require the recapture of unamortized ITC in the event that a Public Utility Commission requires a flow through of unamortized ITC in post-repeal years.

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* The two components are the cost bases of the asset, and the inflation additive.

** The clause provides for loss of the entire ITC for tax purposes due to improper ratemaking treatment.

c. The PTP should provide that established deferred tax reserves must be drawn down from the present 46% tax rate to the new tax rate (e.g., 33%) over the book life of the asset.

Capital formation incentives should be utilized to encourage investments in capital and not provide immediate reduction in utility rates. Normalization ensures that the investment incentives are properly shared between the company and both current and future ratepayers. Notably, utility companies that normalize are viewed by the capital markets as more financially stable and, consequently, their costs of capital usually are lower.

Changes in our tax structure, under the banner of expediency, must not be allowed to aggravate our deficit, to jeopardize jobs, to stagnate our economy, or to make us even more vulnerable to international competition.

In closing, we at United Telecommunications urge you to consider carefully the need for a continued capital formation tax structure at least comparable to the average provided in other industrialized nations. To the extent revisions are made, drastic changes need to be avoided and provisions made for a fair and orderly transition to any new Tax Code.

Thank you.

William T. Esrey